

# Local Government and Economic Development

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# Foreword

This book was prepared under the “Local Government Policy Partnership” Program, a joint project of two donor organizations. The British Government’s Department for International Development (DFID) and the Open Society Institute, Budapest’s Local Government and Public Service Initiative (LGI) launched this regional program in the year 2000. The “Local Government Policy Partnership” (LGPP) projects intend to contribute to policy development and innovation within the countries of Central and Southern Europe (<http://lgi.osi.hu/lgpp/>).

The LGPP hopes to develop expertise and support professional cooperation amongst local government specialists throughout the region. The experiences of the countries participating in this program should be made available in other regions, such as the countries of Central Asia. The core partner countries are the Czech Republic, Hungary, Poland, and Slovakia. However, other countries have been invited to participate in the LGPP regional projects in order to help facilitate direct information exchange and comparison of policy efforts.

LGPP publications include policy studies and proposals that have been presented to government officials and experts in the countries involved. Targeted beneficiaries of LGPP projects are national government ministries, local government associations, research and training institutions, and individual local authorities. LGPP intends to publish three studies a year.

In the first two years of the LGPP project, various policy areas were selected for analysis: education financing and management; regulation and competition of local utility services; public perception of local governments; the relationship between local government size, local democracy and local services delivery; local government and housing; capital investment financing. These policy studies were widely disseminated in the region. They supported policy dialogue (e.g., on education reform in Macedonia) and served as training materials (e.g., for regulatory experts).

Topics for the third and last year of LGPP in 2002–2003 were as follows:

- a) the role of local governments in local economic development
- b) local government borrowing and
- c) regulation on conflict of interest in local governments.

In this volume LGPP project teams have analyzed recent trends in local government borrowing in the Czech Republic, Estonia, Hungary, Poland, Romania, Russia, and Slovakia. They give an overview of the present status of lending to municipalities after

various technical assistance programs have attempted to develop a local credit market in this region. The seven country papers and the summary reports focus on the fiscal and legal conditions, control, and supervision of municipal borrowing. Lending to local governments will be particularly important in the new European Union member countries, in terms of gaining access to EU funding. The policy recommendations formulated in this volume will assist them and other countries with emerging local credit markets.

*Ken Davey*

*Gábor Péteri*

Spring 2005



PART I. •• INTRODUCTION

# Local Government and Economic Development

*Soňa Čapková*



# Local Government and Economic Development

*Soňa Čapková*

## INTRODUCTION AND OVERVIEW

Although some elements of local economic development existed in Central and Eastern Europe under the previous regimes, such activity can only said to have appeared over the past decade.

There is no consistent definition of what is meant by “local economic development.” Generally, it represents a broad strategy in which local actors and institutions try to make the best use of local resources to conserve and create jobs as well as strengthen and promote business activity. This approach attempts to coordinate efforts, improve the conditions and environment in which such initiatives operate, and to place them within the framework of coherent local policies or strategies. It also tries to influence the behavior and internal decisions of firms, since in a market economy business is the driving force for the whole economic growth process.

As mentioned above, local economic development has no single definition; it means different things to different local authorities. For many in local government, economic development is a means of achieving economic growth in order to increase employment and broaden the local tax base. It may involve a number of activities, including the establishment of new institutions, the development of a new or better mix of industries, the support of new and existing enterprises, the attraction of inward investment, and the provision of assistance to stimulate existing employers, produce better goods and services, identify new markets, and transfer new technologies. The term local economic development is often used in a broader sense to include land and physical development.

In his book on economic development planning, Edward J. Blakely (1994) defines local economic development as “a process by which local government and/or community-based groups manage their existing resources and enter into new partnership arrangements with the private sector, or with each other, to create new jobs and stimulate economic activity in a well-defined economic zone.”

There are a variety of ways of classifying the various forms of local economic development activities. Most involve classifying by purpose, separating policies and activities.

Many authors refer to a classification first used by Eisinger (1988), who distinguished between supply-side policies and demand-side policies.

Supply-side policies refer to incentives to attract economic activity into the area, e.g. tax incentives, debt financing schemes, infrastructure investment, regulatory policy, tax increments, land and site development, and financing arrangements.

Demand-side policies are strategies to promote new business creation and small-business expansion, government assistance to local businesses in new product development and market expansion, supporting research and development, strategic investment (e.g., business incubators, venture capital financing, and job training programs).

Many practitioners and politicians use the terms *community* (socio-economic) development and *economic development* synonymously. Despite some distinctions and nuances in various definitions of these terms, *economic development* is usually concerned with the factors that expand the production possibilities of local economies. Local economic development is about creating favorable conditions for business. *Community development* is generally understood as a much broader area of policy related to quality and encompassing such issues as health, education, housing, and environmental quality that may be shaped or influence by the economy.

The link between community and economic development comes through enhancing the competitive potential of local economies by improving production factors in the community. The case for community development spending on infrastructure, health services, education, etc.—frequently deficient in less developed areas—is often justified under the label of economic development.

In the socialist system much emphasis had been placed on the socio-economic context of local development. In Central and Eastern European countries this pluralist view continues to prevail. However, profound changes in local economies since the 1990s has demonstrated substantial economic spillover into the social sphere in deprived areas, especially, changes in the employment structure which has translated into changes in the social structure. Social and economic problems could not be ignored and raised the need to devote particular attention to local economies.

This study is limited to local (i.e., sub-state) economic development and the role of local government in this process in Central and Eastern European countries. Its aim is to examine the ways in which post-communist countries have attempted to develop local economic development policies and explore the issue of the local government along the way. Although the countries surveyed in the book have set up a regional tier of local government and devolved responsibilities in economic development to that tier, our primary concern is the municipal tier of local government.

The first part of the study looks at the general context underpinning the ways in which local governments in Central and Eastern Europe have developed their approach. The effects changes in society have on local economic development are also explored. The introductory chapter seeks primarily to identify the main factors driving local

authorities to engage in local economic development activities as well as to introduce its key concepts and tools.

The next section goes on to look at the actual local economic development policies in six Central and Eastern European countries and discusses the major issues which have arisen during local government reform projects. The chapters in this section discuss the current state of economic development activities and various approaches to local government, taking into consideration the perspectives through which local governments create and implement economic development policies. The central issues—the roles of local government in economic development and the range of choices local authorities face in creating economic development policy—are discussed in six country reports. Local zoning and permit regulations as well as restrictive land, building, and environmental codes are often traced back to problematic growth-related issues. The regulations and alternative approaches to land use and development in several cities of Russia and Ukraine and the extent to which they effect private investment are analyzed in a separate chapter.

The study concludes with a discussion of the continuing arguments about the increasing importance of local governments and its contribution to economic development.

The purpose of this study is threefold—to present a brief review of the role of local government in economic development in Central and Eastern European countries, to make a cross-national comparison of the local government approach to economic development in these areas, and to highlight some of the problems associated with the response of local governments to local economic development issues.

This study is addressed to policymakers and local government professionals responsible for designing or influencing development policies as well as to local economic development researchers. Many studies of economic transition in post-socialist countries emphasize the issue of stabilization in the process of economic transformation and identify the important role of national government in assuring the success of the transition. However, the issue of local government involvement in economic growth has not been adequately examined. For policymakers, the challenge is to consider different factors in their countries and design an appropriate system of local government intervention by sharing strategies and the experience of other countries. The study does not seek to provide rules or templates but to present ideas and examples that policymakers can take and adapt to their own circumstances.

The analysis of local government policies in economic development has been neglected. There have been few attempts to evaluate initiatives, although a small number of examples exist. For researchers, the challenge is to collect data systematically, test various approaches, and verify development concepts. There is a clear need for more empirically oriented studies.

## 1. DECENTRALIZATION AND ECONOMIC DEVELOPMENT

Coulson (1997) defines local economic development as “intervention to strengthen the local and regional economy.” If markets behaved properly, there would be no need to intervene. He argues that commitment to economic intervention by central and local government is an admission of market failure. Local economies get into difficulties in a variety of circumstances. Without help and support, the private sector will not automatically correct resulting imbalances. It will not deal with the complex social consequences of uneven development.

The important role of government in the modern economic system has been generally recognized and accepted, but the role of decentralized government in fostering growth and development has been questioned.

Decentralization is one result of the transition from the socialist system to a market economy in Central and Eastern Europe. Decentralization is usually defined as the process of creation or strengthening (financially and legally) of subnational units of government, transfer of responsibility for planning and management, and the raising and allocation of resources from central government and its agencies to lower tiers of government. Decentralization aims to bring decision making closer to citizens either through administrative reforms or devolution to lower levels of government.

As far as the allocation of resources is concerned, the benefits of decentralized government are usually unquestioned. However, stabilization policies implemented by the subnational levels of government are not always effective (Prudhomme 1995, Tanzi 1996). Criticism aimed at local authorities’ economic development initiatives usually centers on plans to attract firms to an area, i.e., supply-side policies. The main arguments are summarized below:

- Local incentives distort economic activity by creating an uneven playing field across different classes of assets, sectors, or regions; this often results in a misallocation of resources.
- Local economic development policy is not generated in a vacuum—competition across regions may render incentives impotent, but the cost will be incurred nonetheless (a negative sum game).
- Local government provision of incentives (e.g., sites and premises) results in subsidies to firms which do not need it or which may have relocated/expanded even in the absence of these incentives (a zero-sum game), or which replace in the local market firms serving the same demand without subsidy costs (displacement effect).
- The use of local incentives is inefficient because the value of a subsidy to a recipient firm is often less than the cost to taxpayers, i.e., the cost for attracting a new firm is higher than the benefits accrued in the local community.

Despite the criticism of local development efforts, the measures, designed to control macroeconomic imbalances such as inflation, public deficit, and deficit in balance of payment, have been insufficient to reconstruct local economies, reduce local unemployment, and make local firms more competitive.

Critics tend to say that local governments should not play a role in economic development, as it is believed that local authorities cannot aid in stabilization. However, researchers dealing with regional economies tend to support the involvement of local government in promoting economic development. They cite market failure to justify local economic development policy. This raises the issue of whether the local economic development programs should be strengthened further. It must be said that local governments have access to fewer instruments than central governments. But if even the central government acquires this responsibility there is a place for local government. This consideration is based on the assumption that local authorities have more and better information on policies to implement and local decision-making regarding the local setting in terms of particular area circumstances. Local economic development activities may provide incentives to create new jobs if the incentives enable the recipient firm to operate profitably or in creating a business climate that encourages the growth of existing businesses and the establishment of new ones. These activities differ in scale and impact but both are often recognized as inevitable.

## 2. ECONOMIC RESTRUCTURING AND LOCAL GOVERNMENTS IN TRANSITION COUNTRIES

Large-scale decisions regarding fiscal, monetary, and exchange rate policy; welfare and labor policies; and the regulation and liberalization of the market all affect local development in sometimes complex ways. They may foster such development; they may be neutral; or they may hamper it (Viesti 2002). The net impact of transition and national policy decisions have resulted in factory closures and reductions in employment unparalleled in recent history. Local authorities, then, must cope with the high unemployment and economic distress that are consequences of comprehensive structural adjustment.

Besides economic transition, external economic relations have changed considerably. All Central and Eastern European countries aspire to integrate into the European Union, participate more fully in European and global trade, and make an effort to create a favorable environment to increase the flow of foreign capital. There has been significant growth in foreign capital (both direct and portfolio investment), although there have been differences in foreign investment between Central and Eastern European countries and between different areas within each country.

At the same time, regions and municipalities face difficulties that have arisen under conditions of rapid restructuring, increased international competition in an

open economy, and lack of experience with competitive markets. These difficulties include:

- increased unemployment especially among unskilled people;
- a general lack of business know-how as well as a lack of working capital inhibiting firms from acquiring the new technologies required for development and growth;
- lack of business management expertise, particularly amongst small and medium-sized enterprises (including lack of international and national marketing skills); and
- problems penetrating western markets due to trade barriers and lack of experience with these markets.

Many of the most distressed local areas today are suffering because in the past, central governments manipulated their economies by installing a single large employer regardless of its long-term economic viability. Localities with narrow or declining economic bases (such as agriculture or mining) face severe economic problems and have to deal with specific difficulties such as long-term or youth unemployment. Moreover, the regional disparities that emerged under socialism are now giving rise to a new set of disparities caused by their location and quality of infrastructure, thereby influencing the flow of foreign investment that favor countries and regions closest to European Union borders.

On the whole, economic reform and restructuring in the national and international context has resulted in significant quantitative and qualitative changes in local economies that have influenced the need for active economic development measures in many municipalities. Economic changes at the local level are influenced by a wide and complicated range of factors not previously experienced. In all transition countries, actions to address these changes are taking on a greater importance at the local level.

The economic performance of localities is linked to national economic performance. Many local conditions are in fact manifestations of national problems. Slow national economic growth during the past decade has resulted in a slow growth or even a decline in many local economies. Economic restructuring has resulted in particularly hard economic conditions for localities dependent on traditional manufacturing employment, resulting in pressure to take action to provide jobs for local residents. Due to national economic problems, the level of aid from national governments has been reduced, forcing local government to undertake economic development activities using their own resources.

The transition process has required the development of new government functions. A number of these functions must be exercised at the local level to enhance the possibility of local economic viability and growth. Local authorities have had to learn to provide more than the traditional public services. To be successful, local authorities need to understand the demands and needs of the private sector and then intervene



to create a better local environment to support the growth of the private sector. This long-term support for a market economy, which is required at all levels of government, is completely opposite to the traditional bureaucratic interference by government bodies in the business environment.

Within this context local authorities in Central and Eastern European countries have an important role to play in economic development for the following reasons:

- During transition, central governments transferred significant properties and other assets to local government. As a result of property restitution, many local authorities are substantial property owners, with municipalities owning sizeable portions of urban land.
- Local authorities have discretion over a number of important fiscal instruments and capital assets that can be used to provide direct assistance to new and existing enterprises.
- Local authorities also frequently have access to information and extended networks of agencies that can be used to assist new and existing enterprises and help attract inward investment.
- As service providers, local authorities can frequently support new and existing enterprises through the organization and provision of a range of local services to ensure that special needs are met.
- Local governments provide services and manage their own municipal enterprises, which gives them a local market presence as employers or contractors.

Local economic development encompasses many local government functions, including planning, infrastructure provision, real estate development, and finance. The return of competencies to local and regional governments has given rise to more flexible forms of public governance. Decentralization has provided them with additional flexibility in policy processes that can be used to facilitate coordination with other policies, adaptation to local conditions, and broad participation in decision-making.

### 3. POLICIES AND INSTRUMENTS

As mentioned in the previous section, the activities of local government designed to stimulate local economic development are numerous and vary according to the types of support provided. In Central and Eastern European countries, they are predominantly aimed to:

- protect threatened employment levels
- help generate new employment opportunities
- increase the productivity of enterprises through enhanced management and workforce skills and access to new technology

- enhance the attractiveness of the area to eligible firms seeking to relocate or invest.

Local authorities use a variety of tools in their local economic development work to meet these aims. A lengthy menu of possible local initiatives could be classified into five broad categories:

- financial tools
- property-related tools
- marketing
- infrastructure development
- providing technical and information assistance.

This categorization is not rigid and the list could easily be broadened and subdivided according to the range of activities undertaken in diverse kinds of partnership.

The following sections discuss the tools and policies most frequently used in Central and Eastern European countries.

### 3.1 Financial Tools

Support for economic development often needs to be backed by modest support in terms of finance. Where there are disparities in unemployment rates and income levels between regions, local authorities may take action to enhance the attractiveness of their area to new eligible firms and protect existing enterprises by using *fiscal initiatives*, principally through the use of *discretionary local taxes*, especially property taxes. However, it should be noted that property taxes in Central and Eastern European countries have generally played a less significant role than they do, for example, in English-speaking countries.

Local authorities usually have the power to offer concessions or waivers on rates of local taxation as a way to support new or existing enterprises as well as to attract new investment projects.<sup>1</sup> By reducing the tax rate for local businesses, local authorities may try to protect existing jobs, fund new recruitment, or free up cash reserves, enabling enterprises to fund expansion or invest in new equipment. Besides, local politicians have an incentive to broaden the tax base and increase revenues by, for example, promoting business formation and employment. When considering the rationale in a particular case, the decision to grant a concession should always take into account the principle of additionality—the concession must bring economic benefits that would not otherwise be realized. In many cases, demonstrating this can be extremely difficult.

As mentioned above, the possibilities of stimulating economic development via tax incentives are relatively limited. There are other mechanisms that have been used such as *grants, loans, and loan guarantees*. Stable economic environments with reasonable lend-

ing rates and an appropriate legislative framework facilitate the securing of the financial capital required at different stages of business development. However, the accessibility and availability of capital is an issue that national governments should address. The use of local government can make of these tools is usually constrained by tight local budgets.

Aside from providing indirect subsidies to enterprises through tax concessions and direct financial support, some local authorities also play an important role in *providing information on other sources of financial support*, thus acting as brokers of information for interested local enterprises. Information is collected on the availability of funds, eligibility criteria, terms and conditions, and application procedures

## 3.2 Property-related Tools

The extent to which municipal property can be used to promote local businesses clearly depends on the amount of property owned.

In cases where an enterprise has a particular property need which a local authority is able to satisfy from its own portfolio of property, local government may agree to *rent the property* to the enterprise. In order to support enterprises, local authorities may set rents at lower than market rates or devise payments packages that lower costs. An alternative is to provide enterprises with rent holidays or “staggered” rental agreements. Such agreements usually consist of an initial period of months or years during which rent is charged at lower than market rates, then increased in a series of timed stages to reach parity. These agreements are in effect a form of rent-subsidy and are most commonly undertaken as a way to support new enterprises. Where an enterprise has a particular property requirement that a local authority is not able to satisfy from its own portfolio of property, help may be provided in finding suitable sites.

Local governments in most Central and Eastern European countries develop *industrial estates, business parks, or managed workspace*. Managed workspaces (business incubators) offer a range of services based on the provision of suitable land and low-rent premises, targeted primarily at helping small enterprises to develop and expand. In addition to providing appropriately sized and flexible accommodation for new enterprises, a great part of the attraction of managed workspaces is that they provide shared resources and management facilities which it would be very difficult for individual new enterprises to afford. Such premises are often built on municipal-owned land or created through the refurbishment of redundant buildings, usually with substantial grants from European Union or central government schemes.

Local authorities provide property as *collateral for loans* on behalf of local enterprises. Similarly, local authorities offer themselves as *guarantors for loans* in instances where legal guarantees are required. However, the use of property or guarantees carries significant risks.

A distinct subcategory of incentives includes activities centered specifically on the *development of land and/or property*. These include the following:

- land developments such as land acquisition and lot consolidation to create large sites
- land support activities such as infrastructure development
- industrial parks.

There is a need to organize the orderly sale or lease of the best sites through marketing to potential investors. If large companies are to be attracted, they need adequate sites with good communication links. The role of *land-use planning* is to identify suitable sites and ensure they are serviced and marketed.

### 3.3 Place Marketing

Industrial policy was traditionally the responsibility of national governments, but increasingly local governments are crafting their own responses to economic competition. Although competition between places may be intense, local efforts are constrained by existing circumstances.

Regions and cities have turned to marketing themselves using consumer product techniques. This is not a completely new approach, but it has become more significant. In response to rapid change, global competition, and intergovernmental power shifts, local governments have increasingly seen the need to promote their areas in target markets. These target markets include visitors and residents as well as businesses and export markets. Local governments have become concerned with their areas' image. Promotion or "place marketing" is now commonly adopted as a way to support local economic development in most countries. It ranges from *preparation and dissemination of basic information* about the local area to *stands at exhibitions and regular production of bulletins showing vacant land and premises*. When large investments are at stake, considerable attention is paid to the preparation and provision of details on the local area.

Promotion often involves advocacy and lobbying to convince central governments (and in the last few years also EC) of issues specific to the area. This sort of activity is usually aimed at securing access to special financial resources for major public investment in the area.

### 3.4 Infrastructure Improvement

Economic development also includes support for, or provision of infrastructure. It is generally recognized that firms consider three major costs components when making

decisions on location—transportation, labor, and energy (Rubin 1995). Local governments act to improve the attractiveness of their location in these terms.

Investment in physical infrastructure has long been seen as both a cause and consequence of economic development. Infrastructure investments are often seen as a stimulant for promoting local economic growth. Traditionally, infrastructure has been viewed as *roads, highways, airports, and utilities*. The availability of these services has indicated a well-endowed territory. However, in addition to the availability of these traditional infrastructure services, their *quality* (including timeliness, dependability, and capability) has become an important criterion for business development in recent years. Economic development literature (Blakely 1989) suggests that the quality of support services determines the potential for new economic activity.

Improvement of infrastructure is critical to economic development in the municipalities of Central and Eastern Europe. The lack of basic facilities is an obstacle to increasing the productivity of local businesses and attracting inward investment. The advantages of areas are eroded by poor infrastructure.

A further factor promoting endogenous growth is human capital. Public investment in human capital has been acknowledged as a way of facilitating economic development and generating spillovers that increase the productivity of the local labor force. Labor has always been an important component of economic activity, but nowadays employees with a broader set of skills and a more highly educated work force are required. Allocating public funds to improving local knowledge infrastructure and upgrading the level of local human capital are often perceived as those setting in motion forces that result in economic growth.

The relationship between public investment and local economic development is of continuous interest to both researchers and policymakers. In many studies public capital investment are seen to exert a positive and significant effect on economic development.<sup>2</sup> Although results vary greatly, it can be concluded that some local public services clearly have a positive effect on some measures of economic development. That is why many local governments are making great efforts to carry out capital improvements in their regions.

#### 4. PROBLEMS AND STRATEGIES

The common approach adopted by local authorities toward economic development has been primarily concerned with supply-side policies—with promotion and inward investment. Rather than providing a favorable working environment and good locations for businesses already established in the region, local authorities consider questions of regional competitiveness in the context of inward investment. Strategies are intended to create better conditions to attract private sector resources in new productive invest-

ments. The purpose is to attract private, predominantly foreign investment to the community/region on the assumption that such investment has a salutary effect on the community with the result that all residents will benefit. Frequently, incentives (e.g., tax abatements, soft loans, grants, and infrastructure improvements) are key development tools in sparking new investment in the community, even if other more entrepreneurial development tools have been used as well.

The advantages of foreign investments include access to capital not otherwise available, access to modern technologies and know-how, and greatly improved access to export markets as well as existing distribution and sales channels provided by foreign partners.

The potential for job creation from existing firms and new businesses that may be started within the locality has not been sufficiently recognized. New entrepreneurial activity can be more important than attracting large investors. It is unlikely that job opportunities in the attracted firm will exceed the loss in employment. The development of small and medium-sized businesses is critical in restructuring local economies.

Local authorities involved in economic development need to decide who they are trying to influence—new firms, small firms, larger and more established firms or firms from outside the area. Each target group has different requirements, and the instruments available must be used in different combinations. Strategies must include instruments available to local governments, selecting those where there is a need and avoiding duplication.

## 4.1 The Size of Local Government

A critical but somewhat complicating factor is urban size. Urbanized municipalities are much more engaged in economic development, as they have greater professional capability as well as a greater capacity for financial and non-financial interventions. Technical and other information are more readily available in larger urban areas, as are larger pools of skilled workers, capital sources, and amenities. Many of the activities listed in the previous section are likely to be possible only in large cities. In contrast, the hundreds of small municipalities lack the technical, professional, and financial resources to undertake discretionary activity.<sup>3</sup>

At the European and national level, growth concentrates in prosperous major cities (mainly capitals), while the large number of small and medium-sized cities struggle to attract public and private capital and investment. The other fundamental fiscal problem of small municipalities is finding the means to invest in basic infrastructure at an acceptable level. In a large number of areas, local governments' financial resources do not extend to expensive interventions such as the provision of soft loans, grants, and major infrastructure developments. There are many small municipalities with declining

economic and population bases. The small size of many local governments in some countries precludes the possibility of implementing meaningful economic development initiatives. In many cases activities will not be feasible either because of resource constraints, or because activity can be only effectively implemented over a larger geographic area. Local governments try to overcome the difficulties arising from their small size and limited resources by joining forces and undertaking collaborative initiatives. Cooperation in the promotion of local economic development has started recently on a voluntary basis and several solutions in organizing cooperation have been created.

## 4.2 The Legal Environment

External changes in the structure and role of local authorities have resulted in changes in the economic context in which local authorities operate. This impacts on the delivery of some services, particularly in the area of economic development. Economic development is emerging as a policy priority for local authorities in many transition countries. The reasons for this include economic restructuring, national recession, and reduction in state aid.

The new legal framework under which they are entitled to act freely and independently within the limits of their legal authority has also been profound. Local governments have been eager to make and carry out decisions, but are also required to accept full responsibility for their decisions. They are concerned about the creation of new employment opportunities, but in most cases they lack the tools and experience to develop a longer-term strategic framework for economic development.

The type and extent of local government economic activity is dependent on the scope and limitations imposed by state legislation. In some cases, for example, in the area of labor market restructuring, local authorities might not be permitted to undertake meaningful interventions and must therefore defer to other institutions. Legislation governing economic development (such as laws prohibiting certain financial incentives and restricting land ownership and management) has an impact on local policies. Local government activities in the field of local economic development are undoubtedly affected by the public administration reforms currently being implemented in many countries.

## 4.3 Public Pressure

There is a common understanding that local authorities should focus on the functions they are in the best position to perform. Most important among these are the efficient management of local assets and the creation of incentives that will encourage private

sector employment opportunities; they also must foster a regulatory framework that stimulates private sector activities and the mobilization of resources.

In municipalities and regions facing economic problems, there is much public pressure on local officials to “do something.” Even in less stressed municipalities this pressure appears if competing areas are engaged in efforts to attract economic activity. Local officials want to avoid the blame of standing by and doing nothing while the economy continues to deteriorate or when a firm decides to relocate to another place.

Despite the imperatives driving local governments to engage in economic development activities, there are variations in the extent to which they do so. Huge losses in manufacturing employment and low per capita income lead to greater attempts to support local economies. There are also other factors that help to explain differences in the extent and types of local government intervention in economic development—if some local authorities in the region place more emphasis on economic development activities, this can lead to higher levels of activity by other local authorities.

## 4.4 Building Alliances and Partnerships

Over the last few years a growing number of “additional” agencies have been established with a clear role in local economic development. These include regional and local development agencies, chambers of commerce, business innovation centers, etc. Activities range from information and advice to labor training, assistance with sales and marketing, and provision of finance. Most of them are not part of the public sector, although they often obtain substantial funding from central governments. These organizations have emerged from two sources: some are top-down creations funded internationally; others are local initiatives perhaps with some outside encouragement in the form of technical assistance or funding.

There is no obvious best approach to local economic development, and each locality’s strategy will depend on local institutions, priorities, and relationships. Increasingly, local policies involve partnership between public, private, and non-profit sectors. The current emphasis of local policy is to structure growth “from below” with less central direction. This depends on local leaders bringing together many different actors on the basis that they share common interests. The process of achieving local or regional economic development is dependent on the private sector recognizing that it can also take advantage of the ensuing economic benefit. Within this context one of the most important roles local government can play is that of facilitator and coordinator of various economic development efforts.



## 5. THE STRUCTURE OF THE BOOK

The trend towards decentralization has led to a restructuring of the roles of local government in relation to economic development. Local governments have started to undertake new activities, some of which are clearly designed to allow local authorities some scope for stimulating economic activity in their areas. They react to economic transformation in their countries and respond to the possibilities to prepare and implement locally based solutions. Local government implementation might facilitate efforts to coordinate the incentives with planning programs. Local government are often better equipped to cope with local issues, as they have better access to pertinent information and can respond more rapidly to local needs.

The country reports presented in this book provide empirical analysis on the issues previously discussed regarding six Central and Eastern European countries—Bulgaria, Lithuania, Poland, Slovakia, Russia, and Ukraine. Although four of them have also upper tiers of government, the focus here is on the basic level of local government.

Each country study investigates the variety of forces that influence local government involvement in economic development—wider political, social, and economic changes. The country studies also explore local government strategies and initiatives that have relevance to local economics and focus on specific issues of current significance to the respective countries. The authors were given a flexible remit to develop a synthesis of research outputs; however, each country study analyzes the rationale, tools, and practices undertaken by local government. The studies also provide background information on key aspects of local government and economic development linkages, briefly describing the legislation relevant to local economic development. Research that assesses local government actions aimed at stimulating local economic development and identifying the limitations and constraints of local government initiatives in economic development culminates in recommendations and proposals addressed to policymakers at both the national and local level.

The full country reports will be contained on a CD attached to the publication.

Based on the content of each country study and the comparative characteristic of the publication, the basis structure of the executive summaries contain the following issues:

- an introduction to the economic and political environment for local economic development
- the administrative, legal, and economic positions of the local governments
- local policies and activities to promote economic development
- principal issues—the limits to and opportunities for local government development
- a conclusion and policy recommendations.

Research findings are summarized in the final chapter, which discusses the elements crucial to strengthening the role of local government in effective economic development.

## CONCLUSION

Local governments in Central and Eastern Europe were previously passive or reactive with respect to economic change. This changed due to the increasing need to account for economic hardships caused by transition. The need for early and lasting economic restructuring is greater in certain areas, where specifically tailored solutions must be devised. To respond to the challenges of transition, many local policymakers have turned to local economic development policy as means to improve the economic situation and generate revenue. The approaches of specific countries are summarized in the following chapters.

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## NOTES

- <sup>1</sup> Some studies concluded that state and local tax differentials seemed to have little effect on business location, because businesses are influenced by more important factors than differences in taxes.
- <sup>2</sup> The issues of regional and local public investment was investigated in the LGPP project—*Investing in Regional Development* (Davey 2003).
- <sup>3</sup> The size of local governments in Central and Eastern European Countries and their impact on service delivery is discussed in the LGPP policy study *Size of Local Government, Local Democracy and Efficiency in Delivery of Local Services* (Swianiewicz 2002).



# The Role of Local Government in Local Economic Development

Bulgaria

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### INTRODUCTION

The overall goal of this study is to assess the local government policies aimed at stimulating local economic development in Bulgaria. This is done by analyzing the legal framework and the socioeconomic situation in Bulgarian municipalities; identifying the limitations and constraints for local government initiatives in economic development; and establishing the tools and policy practices undertaken by local authorities. General conclusions, recommendations, and policy proposals for decision-makers at the national and local level for improving and fostering local economic development are expressed at the end of the report. The analysis is based on various sources of information—quantitative (presented by the National Statistical Institute as well as local and regional information agencies) and qualitative (studies by OECD and UNDP). A survey was conducted among 400 managers of Bulgarian companies located in different municipalities. Case studies and best practices are also presented.

## 1. THE POLITICAL AND ECONOMIC CONTEXT

### 1.1 The Position of Local Government

Bulgarian territorial divisions and government levels are defined based on principles set forth in the Constitution; however, their specific regulation is provided by two special acts—the Bulgarian Administrative and Territorial Development Act and the Local Self-Government and Local Administration Act.

According to the Constitution, *the municipality* is the basic administrative and territorial unit of local government. It comprises one or more settlements; its territory includes the territory of constituent settlements; and it is named after its administrative center. The municipality is a legal entity. It has its own budget and property used for the benefit of municipal interests. Municipalities provide around 20 percent of all public services. A *region (oblast)* is a central administrative and territorial unit comprising one or more neighboring municipalities. Regions do not form budgets on the basis of their own local taxes and charges and do not make expenditures for the corresponding territory and its population. Being bodies of the central executive power, they receive subsidies from the central budget for the operation of their own administrations. According to the draft of the new regional development plan and in compliance with the requirements of the European Union for allocation of funds for regional development, *6 planning regions (rayons)* have been formed, corresponding to the regions at the level of NUTS II. They are not administrative units and have no financial powers; they are merely statistical.

Municipal financial resources are regulated by two acts: the annual State Budget Act (BSBA) and the Local Taxes and Charges Act (LTCA). Municipalities approve their own budgets outside the state budget. These acts determine the types and amount of received *financial resources* and *expenditures* for services funded from these resources. LTCA regulates municipalities' own revenues in their local taxes and charges section. The Constitution now prohibits Bulgarian municipalities from fixing either rates or taxation bases: taxes are fixed centrally and local authorities have no means to influence them. Local governments have full discretion over local charges and service prices, but because of the traditionally low base of local charges and low incomes of the citizens, the potential for their use for the promotion of economic development are rather limited. Municipal revenues also include proceeds from management and disposal of municipal property, fines, penalty payments, interest, etc.

There are two types of municipal expenditures: for *government-delegated activities* and for *local activities*. Government-delegated activities are those related to the provision of services in the sectors of education; healthcare; culture (partially), and others. Expenditures for these activities are financed by proceeds from the tax on the income of physical persons and a complementary subsidy to the amount of expenditures calculated on the basis of natural exponents. The national standards of expenditures for government-delegated activities can be changed upon suggestions from municipalities (represented by the Task group on decentralization). Local activities are connected to the provision of local services and municipalities may independently determine the type, amount, and quality of these services. These expenditures are financed from own revenues and adjustment subsidies. Certain activities—such as kindergartens and nursing homes—have mixed financing. The cost of such establishments is financed from both from their revenues, with salary and social security expenditures financed from government transfers. The municipality may own *property* to be used in the interests



of the local community. This could include companies, buildings, land, forests, etc. At this particular moment, a process of transferring state property to municipalities is taking place.

According to the legal framework, local authorities have relatively limited powers and responsibilities to influence local economic development. The main tools and instruments to promote (or restrict) the activity of local economic subjects are:

- *Permits and licenses.* Municipal authorization is required to start up a business or carry out certain activities. The municipality provides companies with the majority of building permits; grants licenses for sale of spirits, cigarettes, and other excisable goods; determines the category of small hotels and restaurants; determines working hours, etc.
- *Charges.* These are for all kinds of municipal services, including markets and market-places, the right to sell goods on sidewalks, waste disposal charges, etc.
- *Leases.* Large parts of municipal property (grounds, floor areas, and other real estate) are rented out to businesses.
- *Sale of municipal property.* These could be whole enterprises or parts thereof, shops, warehouses, grounds, etc.

Implementing the above, local authorities create jobs; collect taxes and other revenue for municipal budgets; restructure municipal activities and services provided, etc. Creating efficient methods for company start-up and activity is a way to promote local economic development. On the other hand, selling or leasing property can expand and improve the environment for business development and create conditions for competition. Presently, most municipal authorities are not actively using such measures on a significant level, due to a lack of good information about the resources needed for implementation and benefits to all concerned, as well as due to time limits.

## 1.2 Limitations and Future Developments

The ongoing process of local government reform and the *financial decentralization process* started at the beginning of 2003 and are expected to better allow municipalities to influence economic development. Local government reform processes are implemented along several basic lines: changes in territorial structure; delegation of powers and financing; transfer of state ownership; and the broad involvement of civil society. The enhanced role of local authorities in promoting economic development is largely connected with further decentralization, providing greater opportunities for local authorities to improve the quality of services and the business environment; and to increase public commitment and activity in terms of local participation and control. According to the concept of

fiscal decentralization, local governments will be motivated to increase local revenues, as that will not result in lower government subsidies. Amending the Constitution and delegating the power to determine local tax rates to local governments will also increase the range of possible tools.

A draft law for the creation of industrial zones is discussed and its approval and implementation is expected to boost local economy development. A part of the territory of the country could be deemed an industrial zone where certain tax and other incentives and relief are submitted. The Council of Ministers could define the zone after a proposition from local governments, regional governors, and the minister of economy or a group of investors themselves. There are such propositions for the creation of industrial zones in different municipalities. Main incentives will be tax relief, comfortable labor regulations, concessions, etc.

Currently the *relations between local authorities and business communities* are rather limited. Attempts to restructure and diminish local government expenditures broadly exercise the practice of contracting out certain local public services to private companies—cleaning, road maintenance, water-supply concessions, etc. There are examples of municipal-private partnership in construction, social services, and other sectors, but they are not widespread. This partnership needs substantial improvement. Because of their poor financial performance local governments often delay payments. The lack of managerial potential and the highly centralized financial system, where local governments are not motivated to increase local revenues, because they will get less government subsidies, are also important limitations.

The process of democratization in Bulgaria is at its initial stage, especially on the local level. For the time being, local authorities appear to be mainly re-distributors of budgetary resources and deliverers of a limited range of administrative services. This is partly due to lack of experience and capacity, as well as to the strict controls in the Currency Board Agreement. The municipal structure in Bulgaria is good enough to carry out the tasks of local economic development, but horizontal links between individual municipalities and the vertical links of intergovernmental relations need to be designed more clearly and to made more helpful for the process of decision-making on local level. The process of fiscal decentralization—of crucial importance to local government—must still be accelerated.

### 1.3 The Socioeconomic Environment for LED

In recent years the development of Bulgarian municipalities has been characterized by *disparities in socioeconomic development*. These disparities are the result of the inherited socioeconomic and territorial structure, past policies, and the development dynamics in the period of transition to a market economy. There are disparities in economic devel-

opment, employment, income, quality of life, etc., represented in different indicators: GDP per capita; proceeds from the activity of economic subjects per capita; employment, and unemployment; income per capita; own revenues in municipal budgets per capita, etc. An important factor determining the socioeconomic status of Bulgarian local governments is the transition to a market economy. Different regions have adapted at varying paces. This is independent of their size or assets, depending instead on managerial potential and the economic activity of local authorities, the quality of privatization and the development of public-private dialogue. Corresponding indicators include the level of private sector penetration, SME development, the structure of economies, and the allocation of foreign investments.

The analysis leads to several *conclusions*, which can serve as reference points for basic policies and recommendations for ways local governments can encourage economic development:

- There is currently only one level of local self-government in Bulgaria—municipalities. The basic responsibilities of local authorities are highly limited—brought down to mere distribution of the scarce budget funds and delivery of a limited number of services.
- Bulgarian municipalities are characterized by significant variation in levels of social and economic development. These differences are most pronounced in terms of investment capacity, poverty, and general social and economic status. Many municipalities suffer from geographic and transport detachment as a result of underdeveloped infrastructure and highly reduced public transport; absence of developed and effective economic activities; heavy unemployment; the depopulation of some towns and villages; impeded access to information, contacts, and markets; and low public services support. These differences, along with reactions to the transition process, determine different priorities of individual municipalities and the guidelines of their economic policy.
- Demographic factors have a serious effect on municipal economic development potential. Depopulation of certain regions, migration, and different levels of education and qualification among the labor force all come to bear on implementation of economic policy.
- Many municipalities are characterized by a lack of entrepreneurial skills and an indisposition to operate in a market environment, conform to the processes of globalization, or become successfully involved in international production networks. Consequently, the business community cannot actively partner with municipal authorities in developing and implementing specific economic policies.
- General social and economic status is low and central, prompting local authorities to support competition among local business as a way to promote sustainable economic growth.

- Foreign investments are geographically concentrated in only a few regions, leaving most municipalities with little of its benefit.
- Decentralization of local government, though already launched, is still in its initial stages. Expansion of reform is expected to provide local authorities with wider opportunities to influence economic development—greater freedom in making decisions on economic development, more high quality business and public services, greater opportunities to implement projects and improve infrastructure.

## 2. THE ROLE OF LOCAL GOVERNMENTS IN ECONOMIC DEVELOPMENT

National economic policy is aimed at building up potential for long-term economic growth and sustainable development. Part of this policy consists in creating favorable conditions and solving problems at the local level in order to mobilize local resources. Local development policies aim to restore economic balance by neutralizing local market deficits, encouraging local economic growth, and reducing regional disparities.

### 2.1 Players in Local Economic Development

Sustainable development of Bulgarian municipalities requires strong commitment and active participation among all players in local level economic—municipal administration, local businesses, the NGO sector, and citizens. Partnership and optimal distribution of powers and obligations are critical to economic development. *Municipal authorities* are in charge of creating proper conditions and developing infrastructure, municipal property privatization, supporting ecological projects, and introducing transparent management systems. *Local entrepreneurs* are challenged to maintain local economic activity during economic restructuring, with limited financial resources. *NGOs* aim to support groups participating in joint regional, national, or international social and economic development programs.

#### *Municipal Authorities*

Municipal administrations in Bulgaria have the potential to influence local economy. Currently they may intervene by:

- promoting economic activity through fees (for the use of markets, marketplaces, fairgrounds, sidewalks, roadbeds, etc.)

- promoting certain trends in private business development by way of public infrastructure investments
- direct participation in projects which involve municipal property and can become a basis for public-private partnerships
- promoting initiatives through aid in financing (providing guarantees, encouraging credit cooperatives, etc.).
- providing efficient public services to create clear and transparent rules for businesses.

Currently municipal authorities are not active in influencing local economic development because of a lack of managerial experience, insufficient financial resources, and due to certain centrally imposed limitations (in cases where initiatives are both economic and social). That is why the role of municipal authorities in economic development can be assessed as limited. Municipal economic activity is still subsidized, and the central administration does not intend to give more fiscal freedom to local governments until a well-designed system of control is implemented. Privatization of enterprises providing public services (municipal monopolies) is often delayed because of suspicions that private enterprise will not be able to guarantee better quality of the provided services. Creating a clear and transparent framework for entrepreneurs by providing fast and efficient services is at its initial stage. Local governments understand the importance of this issue but most are yet to create the necessary organizational support structures.

In 2004, privatization was expected of companies responsible for road maintenance, public lighting, central heating, water-supply, sewage, planting trees and gardens, and municipal improvements. The major question was whether local governments would be able to influence the regulation of privatized companies. Even now most are regulated at the national level, with local governments unable to implement their own policies.

An important strategy to promote local economic growth is the development of municipal infrastructure, which means investing substantial municipal financial sources. Such local government investment has a clear impact on local production capacity. Increasing local government investments leads to increased efficiency for private sector investors. Investment activity is limited due to of lack of financial resources. Only geographically large municipalities can make use of the basic opportunities to finance municipal infrastructure projects: domestic bond issues, Eurobond issues, and bank loans. The use of instruments depends on the amount of the municipal budget, the needs of the corresponding project, its urgency, opportunities to seek an internal return within the project, etc. Municipal bond issues are not common in Bulgaria, so bank loans remain the most common fundraising instrument for municipal infrastructure development.

### *Entrepreneurs*

Entrepreneurs are actors in local economic development, but in some cases the interests of private business conflict with the social priorities of municipalities. Therefore, the clear distribution of roles between municipal administration and business is of paramount importance. Private companies operate under certain institutional, fiscal, and infrastructure conditions, which are in many cases subject to municipal decisions. Successful economic development requires dialogue and partnership in assessing different policy options.

With the development of a market economy and the strengthening of local authorities' powers and responsibilities, local business representatives play a much more active role in municipal administration and may realize specific visions for economic development. So, cooperation between local business and municipal administrations becomes crucial. Yet, observations, surveys, and interviews carried out in Bulgaria reveal that in many cases local business representatives remain passive regarding their role in local development. There are two possible explanations—first, entrepreneurs underestimate their own importance, and second, they overlook the role of dialogue and cooperation with municipal administrations. There are currently no efficient mechanisms in place to encourage communication between local businesses and municipal authorities. Where such communication does take place, however, cooperation between the two communities is quite efficient.

### *Nongovernmental organizations (NGOs)*

With the withdrawal of the state from a number of social functions, making room for potential activity of third sector organizations (social services, training, business support, etc.) nongovernmental organizations took on an important role in the economic development of Bulgarian municipalities. They may carry out economic activity, provided that it conforms to their principal activity. In many cases such organizations are mediators in the inflow of foreign investments to municipalities. They have qualified experts and offer unconventional solutions to various municipal problems, which makes them exceptionally useful in municipal decision-making and development. Opportunities for such organizations to work and take part in promoting municipal economic development will probably expand (particularly in the field of social services).

## 2.2 Policies to Support Local Economy

### 2.2.1 Preparing Development Strategies and Programs

The first step for promoting local economic development and defining and implementing economic priorities is the elaboration of municipal strategies and programs for social and economic development. Such strategies are already developed in many Bulgarian municipalities with the support of various donor organizations. Such documents are also drawn up with a view to successful participation in EU structural and pre-accession funds.

These strategies outline *the framework of local economic development* and define basic priorities and the specific activities for their implementation. Local authorities take a leading role in their development. Teams are set up to develop analyses of current social and economic situation of municipalities, of the strengths and weaknesses of development, and outline basic trends. In some cases these teams are set as specialized economic structures within municipal councils equipped with qualified experts who develop strategies and programs to attract new investors, market the economic potential of the region, support business, etc. These structures are expected to be of great importance for municipal economic growth.

*Municipal development plans* are elaborated and implemented on the basis of these strategies. They are an integral part of the Bulgarian national and regional development planning and are usually carried on with the support of international donors and NGOs. Three pilot-projects have been finalized up to this point, resulting in the publication of a special project planning manual. With support from the central government and international donors, *regional economic development programs* have been designed for a number of Bulgarian municipalities with the conditions for sustainable economic development. Based on in-depth analysis of local enterprise and the labor market, programs primarily address widespread unemployment and the difficulties related to economic restructuring; programs aim to achieve financial and economic stability, create new small- and medium-sized enterprises, generate new jobs, and improve the general welfare of the population.

Still, contact with donors and access to advice from nongovernmental communities tend to favor larger, more developed municipalities, while small, less developed municipalities are unable to approach local development programs, instead insisting on the redistribution of funds from the central government as the key to providing services for the business community.

### 2.2.2 Effective Management of Municipal Property

Poor economic conditions in Bulgaria mean that local authorities dispose of a rather limited amount of assets or *own enterprises*. Municipalities usually subsidize public service provision, as enterprises involved in provision rarely operate at a profit. Mostly this is due to a lack of qualified managers who are comfortable in a competitive environment. Poorly managed municipal assets do not promote private business activities for three reasons: they do not provide the necessary services to the business community; they do not create a convenient environment for increasing activities of other related companies; and they do not attract the attention of investors. In recent years local authorities aim to improve management through privatization of municipal companies.

Companies providing public services are subsidized in order to maintain quality and level of services at an acceptable standard. Local authorities cannot, then, merely liquidate companies operating at a loss, as the services they provide must continue. In order to promote efficiency, local authorities tend to separate activities to create competition and use concessions actively to protect public interest. Most Bulgarian municipalities will require more time to develop the experience necessary to manage such mechanisms successfully.

*Real estate* is another source of influence over local economic development. As a rule, such assets are leased or used for proprietary needs. Often publicly owned property does not generate a profit, on the contrary—it accumulates expenditures, as it is used to deliver public services, the cost of which does not include depreciation or repair and improvement expenses. By leasing real estate to private companies (especially in terms not fixed on market principles, as is common in Bulgaria) local authorities directly influence the business environment and the real cost of doing business.

With the ongoing decentralization process and attempts to apply regional policy, the central administration clearly intends to maintain a minimum amount of property and assign the rest to municipal authorities. Local governments require greater managerial capacity to adequately address public needs. For the time being only a small portion of the municipalities have insisted on and received sizable state property earmarked for use in improving the business environment and promoting local economic development.

### 2.2.3 Supporting Local Business

*Improving the business environment and facilitating start up of new businesses* is the way most local authorities can most aid in promoting economic development. In surveys, company managers tend to criticize the competence of municipal officers, citing corruption, unclear and contradictory administrative procedures, time-consuming licensing



bureaucracy for new business, and ensuing increase in *transaction costs*.

Municipal administrations' most important instruments for the improvement of business environment and promotion of entrepreneurship are as follows:

- *Entrepreneur's shops* to support companies in obtaining business information and the required licenses and documents. Such shops have been set up in many Bulgarian municipalities and the effects of their work have been positive.
- Ensuring observation of the *principles of publicity, transparency, free and fair competition, and equal opportunities* for all applicants in the implementation of the Public Procurement Act.
- Introducing *accelerated procedures* for granting licenses and permits to SMEs.
- Promoting *partnership and cooperation* among SMEs in individual sectors, as well as between sectors.

The implementation of these instruments is still in its initial stages. They are used mainly in municipalities working on donor-funded projects. The majority of municipal authorities are well aware of the importance of improving the business environment and draft measures accordingly, but results are still negligible. Both municipal administration and entrepreneurs suffer from a lack of experience in using instruments for improving business environment, but best practices in this direction are a profound inspiration for other municipalities.

#### Creating business centers, business incubators, and technology centers

Business centers, business incubators, and technology centers proved to be relevant instruments for solving some of the problems facing entrepreneurs. These have been used extensively in recent years to support entrepreneurs. They are created mainly under programs supported by international organizations and donors. Some local authorities do play an active role (in cooperation with local business and donors) in setting up business agencies, business centers, and business incubators; they may be founders or permanent members of business centers, or provide free buildings and grounds for extended periods of times. Municipal administrations are already deeply convinced that business centers and business agencies are a mechanism for accelerating economic development, transforming the economy at the local level. In many cases these agencies are a catalyst for the establishment of other necessary NGOs.

The UNDP-supported Jobs Opening through Business Support (JOBS) Program with the Ministry of Labor and Social Policy initiated the creation of business centers covering 24 municipalities with high unemployment rates. These centers offer free information, financial and administrative services—also providing free internet access. Leading experts provide consulting services and organize seminars to improve skills in finance, accounting, management, computer literacy, and foreign languages. Though these centers, entrepreneurs also receive support in preparation of registration documents, development of business plans, etc. Centers offer loans for leasing property,

provide market information, help in preparing advertising materials, and assist in the development of websites.

Business incubators offer free premises, assist with administrative expenses, and pay a portion of electricity bills for entrepreneurs. They provide consulting services, training, information, micro-credit loans, etc. Today, 11 municipalities have functioning business incubators where tenants share office space, interpreters, e-mail providers, computers, and conference-rooms. Every business incubator offers leasing schemes for support of local entrepreneurs. Business incubators have contributed to the generation of new jobs, facilitated procedures for the start up of new businesses; provided communications support, access to financing, training, consulting services; and provided market and other business information.

As local enterprises demonstrate an enormous need for information—mainly concerning markets, new technologies, and opportunities for loans—business centers and business incubators give ground for effective exchange of market and financial information by making use of business support structures such as entrepreneur's shops, regional development agencies, and other NGOs. Support for local economic development and cooperation among businesses will improve with the creation of a general database of all business centers and incubators in Bulgaria; as such a database can facilitate exchange of business information through the development of special municipal business websites with corresponding links.

### *Improving the capacity of local administrations to support business*

The efficiency and competence of municipal administrations are important for the support of local business. Under modern conditions, improving the competence of municipal administrations implies building off *scientific and technological progress* to facilitate business and improve communication between citizens, the private sector, and local government. Therefore, many Bulgarian municipalities strive to modernize as quickly as possible, limited both by lack of financial resources and lack skilled personnel. A few municipalities have digitized institutional documents and their circulation, making documents accessible both to officials and citizens.

A current priority is the development of a website with PDF forms explaining administrative procedures in plain language. Such a site can provide to certain executable services online. This is useful and time-saving, but only for the 12 percent of the population for whom it is available. Further improvements include:

- monitoring quality of the services provided by municipalities to business
- improving information exchange within the municipality (intranet)
- improving qualification of municipal administrations, particularly in terms of work with information technologies
- developing a mechanism for evaluation of every municipal official

- promoting exchange of information and experience regarding municipal problem solving.

### *Municipal marketing to attract investment*

Foreign investments are scarce in many Bulgarian municipalities, leaving little to report. Due to the difficult economic situation throughout the country, developing aggressive marketing strategies is of crucial importance. Municipalities need a multi-component action plan for attracting local and foreign investment in order to create jobs, generate an effective local business environment, and stimulate municipal activity.

Municipal marketing profiles not only attract foreign investment, but encourage local economic development as well. In this context, the increased capacity of the municipality to recruit foreign business is also a benefit. At the same time, private investors preparing to bid on municipal projects also use these marketing profiles. Though it is difficult to measure the increase in capacity, the fact that almost all Bulgarian municipalities have indicated their interest in this tool is proof of its positive effect.

### *Improving local infrastructure*

The central administration plays a leading role in Bulgarian infrastructure policy, whereas municipal and regional administrations have responsibilities and powers to develop and implement specific programs conforming to central government decisions. Nearly all infrastructure projects are state-owned. The national road network, the railroad network, public ports, and airports were declared public property; consequently the central government controls their development. Operating companies own communications, power, heating, and gas networks. The state is the sole proprietor of almost all operators. As of today, exceptions include Toplofikatsia Sofia, a municipal company, and private mobile phone operators. The gas distribution networks under construction in the last decade mainly count on private business initiatives and are owned by private business. Nevertheless, gas infrastructure development plans are coordinated by the State Energy Regulatory Commission. The fourth class road networks are municipal property, and in some cases local water supply and sewage systems are also municipal property. But as they are part of the general network, their development must also be coordinated with higher administrative levels.

Infrastructure services still tend to be provided by state-owned companies, but private companies have already penetrated the communications and gas distribution sectors. The Municipal Property Act enables local authorities to set up municipal companies for the provision of public utility services, construction and maintenance of municipal infrastructure, or provision of transport services. Municipal administrations retain the competence to assign these activities to other companies by concession and grant of necessary licenses.

Recent changes are aimed at improving the status and service of the infrastructure. The private sector has, by presumption, better management skills and can contribute to the achievement of this goal not only by investments but also by the introduction of new technologies, transfer of know-how, and better management of relations with clients. However, private sector penetration of infrastructure sectors makes the issue of effective regulation crucial. The absence of an orderly system of regulation, control, and sanctioning of operators who do not fulfill their commitments is a glaring deficiency. Private monopolies could even result in failure to provide infrastructure services to corporate and individual clients in thinly populated places throughout a region. Many problems are rooted in the fact that Bulgarian administrations—both local and central—lack experience in infrastructure service regulation.

The restricted powers of municipalities to determine infrastructure policy constitutes a major limitation in their capacity to contribute to the improvement of infrastructure and related services. However, this could encourage municipal administrations to innovate beyond current practices. Given that infrastructure projects could both attract new investments and generate new jobs, municipal administrations could stir the public, business circles, and the nongovernmental sector to greater activity, and lobby to create a better infrastructure environment.

#### 2.2.4 Stimulating Employment

According to the Employment Promotion Act, “the state shall implement employment policy in cooperation and after consultations with representatives from employers’ and workers’ organizations and representatives of other non-profit legal entities.” The Ministry of Labor and Social Policy (MLSP) develops an annual National Action Plan for Employment in cooperation with other ministries and social partners. Municipal administrations participate in the employment commissions on Territorial Regional Development Councils. In carrying out their activity, these councils take into account the National Economic Development Plan, the National Regional Development Plan, the National Action Plan for Employment, and the Regional Development Plan, as well as municipal development strategies and plans. Municipalities step in, as they develop *local development strategies and plans* conforming to municipal needs and capacity. Organizing meetings with business representatives and the unemployed, municipal administrations help to *identify the type of labor force* entrepreneurs need, with a view to match demand with supply, reduce unemployment (through the *implementation of programs to train and retrain the labor force*) and ensure an efficient labor market.

### *Programs promoting employment*

*The national program “From Social Support to Providing Employment”* began in 2002 with the participation of municipal administrations. Its basic objective is to provide employment and social integration to persons long unemployed and on monthly welfare benefits. This is accomplished through well-managed jobs in socially useful activities for the municipality and state. The program was developed by the MLSP in accordance with employment and social integration policy. The program was implemented in all Bulgarian municipalities and is financed with allocations from the state budget to LSP’s active policy budget for the corresponding year. On principle, the program is implemented on the basis of annually approved municipal quotas conforming to the needs notified by municipalities. Municipal administrations and municipal enterprises are eligible employers under the program, which benefits the municipality and the local population and supports socially useful activities.

*The project “Improving Employability and Encouraging Entrepreneurship among Young People”* is another mechanism implemented with the participation of municipal administrations. It was developed by MLSP and includes two modules: employing young people with higher education in public administration and encouraging entrepreneurship among young people. The project also targets increased employment of young people by improving their employability and entrepreneurship. The first module will enable young Bulgarians to find jobs upon graduation, and the second one will allow improvement of the qualitative characteristics of young people through entrepreneurship—ultimately aiming to lower unemployment levels and establish a healthy labor market. Municipal administrations participate in implementation by providing information as well as space for the operation of youth centers and independent business.

*The JOBS project* mentioned in the previous section aims at enhancing economic development in areas with high levels of unemployment by creating a sustainable environment for job creation through support to small companies and agricultural producers. With the help of this project a model for stimulation and creation of micro- and small enterprises has been developed. The project has been implemented in 24 communities throughout Bulgaria and was prolonged for another 3 years (2003-2005) to cover 10 more municipalities. Project participants engage in annual discussions on best practices in local business promotion and working partnerships between private business, business organizations, NGOs, and international partners. Information centers provide access to modern technology, also offering courses on computer literacy, advertising, and locating partners abroad. 53 marketing and production groups have been established in the framework of this project. The new strategy for 2003-2005 aims to establish a national network of business centers, improve efficiency, and create new international contacts.

### *Tax policy mechanisms for promoting employment*

Local authorities have little ability to set local taxes and charges; consequently, opportunities to make use of these mechanisms are rather limited. Local authorities are largely deprived of the opportunity to influence the planning of their own revenues in a way that could encourage growth. Amendments to the Corporate Income Tax Act of 2002 concerning regions of high unemployment were aimed at promoting investment in those regions. Tax relief for production activity targeted companies in 117 municipalities (44 percent of the country), which will enjoy 100 percent ceded corporate tax for 2003. According to these amendments, production companies, including those operating under processing agreements, will be tax exempt. Companies will benefit from zero rates where assets covered by the Accountancy Act are entirely within the administrative boundaries of these municipalities, along with 80 percent of the average payroll tax for personnel employed under labor contracts for the year for which the tax is ceded, who are permanent residents of said municipalities.

The approved zero rate of profit tax for regions with heavy unemployment is a typical example of ongoing *centralized solutions to municipal problems*. Given the central government's decision that municipalities should retain the full amount of individual income taxes raised on municipal territory (with the exception of 35 municipalities assigned an individual percentage ensuring revenues up to the amount of activities delegated by the central government) and considering that profit tax goes to the central budget, it is clear that regional economic policy will again be implemented with central "pressure." A successful decentralization process requires that municipalities be allowed to decide independently whether to apply the zero rate (currently impossible due to a constitutional ban) because it may well turn out to be a double-edged sword.

### 2.2.5 Working in Partnership

During the last 4–5 years a number of initiatives developed in many Bulgarian municipalities encouraging cooperation and partnership between local authorities, the corporate sector, and civil society. Priorities of this cooperation are the delivery of programs and services consistent with local conditions and allocation of resources in a way conducive to sustainable development. These partnerships facilitate consultation, cooperation, and coordination. At the moment it is quite a new process and not so many cases of long-standing mechanisms and sustainability can be reported. Relations between businesses, citizen organizations, and local government can be characterized by the following:

- The assumption that the state holds all responsibility for the solution of community problems significantly hinders active citizen participation.

- Local governments tend to distrust new local businesses and citizens' organizations, preferring to cooperate only with well-known and well-positioned organizations.
- Partnerships which complement and expand the limited financial and human resources of state programs predominantly target the most urgent community needs (i.e. social and medical care, employment and integration of marginalized groups) where initiatives of different organizations.

The existing practices in Bulgaria demonstrate a variety of approaches and forms of partnership. Non-profit organizations tend to best identify important problems, elaborate a project proposal, propose partnerships with the local government, and take responsibility for project implementation. Sometimes citizens' organizations initiate a partnership and "import" best practices from international experience. There are a few cases when initiatives were started up by local authorities. Municipal administrations acknowledge more and more the importance and benefit of joint projects. Sometimes they even allocate special budget lines for future initiatives. The tendency to seek cooperation with business communities and NGOs went beyond incidental manifestations and shows a trend toward stabilization and even institutionalization. Though this is a slow process, and municipal officials are sometimes highly suspicious of partnership, Bulgaria has seen the first steps toward partnership—important community projects have been completed and models of cooperation have been developed in accordance with local needs.

Partnerships for local economic development have been developed since 1997 under different international programs, such as the Ump's Agenda 21 Century Program, PHARE democracy programs, the PLEDGE program etc. The main goal has been creating sustainable development by stimulating action and dialogue involving citizens, the business community, local governments, and other interested parties. Progress has been made, but a solid system of horizontal relations between the different partners is still needed in order to achieve optimum coordination. Local administrations, business, and nongovernmental organizations have different interests, and the first thing they need to do is reach a consensus on common.

## 2.2.6 Successful Use of EU funds

EU pre-accession programs are becoming interesting and important instruments in local economic development. In Bulgaria, municipalities are the only territorial units to apply for the absorption of resources from these funds, as they are the only units to have their own resources to execute investment projects. Since July 1, 2003 Bulgarian municipalities could take advantage of SAPARD program (for promoting development



in rural regions) along with PHARE and ISPA. 231 municipalities (out of 263—making 88 percent) are defined as rural and can benefit from newly agreed measures under the SAPARD program.

As beneficiaries of pre-accession funds, municipalities have a specific role in the accession process. Most are ill prepared to play this role, but there are a plenty of success stories as well. With the help of donor consultancy and NGO expertise (specifically from the National Association of Municipalities), municipalities participate successfully in the distribution of structural funds. Municipal representatives take part in the working groups that prepare programs, in the commissions that approve projects, and in the monitoring committees that control the process of fund absorption.

There are many obstacles in the process of application for pre-accession funds and maybe the most important for Bulgarian municipalities is the “high cost of project preparation,” including feasibility studies, environmental assessments, land purchase, technical and construction designs and, especially, lack of financial resources (the need for commercial credit) for the co-financing of some projects. Small municipal authorities usually stress insufficient information, ignorance about the European integration process as a whole, language barriers, lack of established partnerships between civil society and the business community, etc. The Foundation for Local Government Reform has launched long-term *training programs* on modeling municipal development policy, understanding the financial instruments of the EU, project development, and project management.

Still, practice shows that it is not the size of the municipality that determines capacity for the absorption of funds. Some small municipalities successfully apply sophisticated strategies for municipal development, which have a clear vision for long-term local development, and are designed using outside consultancy but with the active cooperation of municipal authorities as well. Only realistic and concrete strategies can be the basis of successful projects.

### 3. GENERAL CONCLUSIONS AND RECOMMENDATIONS

- Responsibility for local economic development is shared between all local economic subjects—municipal authorities (who must deliver high quality public services and create favorable conditions for business), entrepreneurs (who must maintain local economic activity in specific conditions), and NGOs (who support the two other communities).
- Development depends on defining basic priorities, elaborating strategies, and implementing programs.
- Most municipal authorities dispose of a rather limited amount of assets or own enterprises in poor financial condition. Still, management of a municipal prop-



erty fund is an important instrument for the implementation of own policy by ensuring the delivery of services of a higher quality to businesses and citizens.

- Business support policies promote local economic development. Setting up one-stop-shops and creating business centers and incubators help solve problems with information access and facilitate service delivery. Creating clusters and networks shifts attention to a higher level—from individual industries to links and cooperation among and between industries and companies.
- Though intended to attract foreign investments, tools such as municipal marketing profiles, investor orientation programs, and industrial zones can be used successfully for the local promotion of businesses as well.
- Stimulating employment is a joint responsibility of the central and local governments, and cooperation is crucial for the final success of each program or concrete measure. Programs elaborated at the national level are implemented at the local level and their effectiveness depends on municipal activity. Most were launched recently, precluding analyses of results. Donor programs have been designed specifically for implementation in a specific location, make case-by-case analysis necessary.
- Building partnerships between local government, the business community and NGOs is a priority of many municipalities, still hampered by local authorities' distrust of the newly-founded business entities and citizen organizations, with a deeply rooted understanding of the responsibility of the state for the solution of community problems.

Municipalities have a specific twofold role in the accession process—they are both partners and beneficiaries of pre-accession funds. An important condition for efficient utilization of EU resources is raising the absorption capacity of municipal authorities as a profound basis for drawing successful projects.

Analysis of social and economic development in municipalities and policies for support of economic development has led to the following recommendations:

First, there is a need for consensus among a wide circle of political forces to develop a clear vision of the role of local authorities as a generator of economic and social policy. Therefore, it is necessary to continue the process of *local government reform* along several lines—to optimize territorial structure, delegate competencies and higher autonomy to local authorities, transfer state property, and optimize financing. Another range of issues should be added—the participation of the civil society in the performance of local governance. The basic objective of these changes is *to enable municipalities to implement effective local policy and improve services for individuals and companies*. Successful reform implies:

- improved local self-government regulations
- strengthened local fiscal capacity and greater fiscal decentralization

- greater competence among local government personnel
- assistance for civil organizations who support local government
- improved communications and administrative capacity
- effective fiscal control.

Second, in terms of the *optimization of territorial structure* there is a need to build a *second level* of local self-government to support vertical links and enable the expansion of local self-government at the regional level. This new level can be delegated real functions related to issues going beyond the capacity of municipalities (for example, infrastructure, healthcare, education, regional development, information about regional economic status, the prospects for its economic development, etc). It would be much more difficult and less efficient for these topics to be managed by individual municipalities.

EU regulations also point towards a similar solution. According to these regulations, countries receiving fiscal support for social and economic cohesion through corresponding fiscal instruments (funds) must first plan their regional development measures and activities at the NUTs II level, corresponding to the six planning regions (Northwest, North Central, Northeast, Southwest, South Central, and Southeast). But these planning regions do not have any fiscal powers. This means that the implementation of municipal development programs and plans remains within the competence of municipalities and will be financed from municipal budgets or out-of-budget resources.

Third, in terms of *the competence and autonomy of local authorities*, there is a need to actually delegate more administrative functions to self-government bodies. At present many Bulgarian government structures are represented by units at both the municipal and regional level, but their cooperation with local authorities is limited. Examples include tax authorities, welfare services, labor offices, and agricultural services. All these units representing a ministry at the municipal level should be coordinating and cooperating with local authorities. It is enough for the central government to keep its capacity for methodological guidance and control. Consequently, there is a need to:

- *Define and legally specify* material competence, including tasks and the territory where they should be performed.
- *Guarantee certain sovereign rights to municipalities.* Some of these are in place; others have to be realized as a part of decentralization. Local authorities should gradually be delegated all powers related to efficient performance of their obligations following the subsidiarity principle.
- *Increase local fiscal independence by transferring a greater portion of state property.*

Fourth, *successful implementation of the fiscal decentralization process* requires the following:

- Clearly divide responsibilities between different government levels.

- Improve and stabilize the system for the redistribution of budget revenue between municipal and central budgets. Target financing of delegated activities from the central budget.
- Expand the right to determine charges and taxes, accompanied by enhanced political responsibilities.
- Enhance municipal capacity to manage municipal budgets, including planning, cash services and deficit financing.
- Improve the adjustment transfer system to take better account of municipal needs.
- Guarantee efficient management of municipal property by more effectively focusing welfare benefits on the needy.
- Improve accountancy and control of local authorities.

Fifth, the *participation of the civil society* in the decision-making process is a guarantee for building new, democratic local self-government in Bulgaria. Local self-government must perform the following tasks:

- Support and direct municipal economic development.
- Involve business and individuals at all stages of government and treat them as partners.
- Focus attention on entrepreneurs and track public opinion to show that municipalities truly serve businesses and people.
- Work as real entrepreneurs and look for innovative solutions to improve efficiency.

Sixth, the following policies could enhance the role of local authority's economic development:

- *Delegate to the municipality the management of state-owned assets on its territory.* Special attention should be devoted to the efficient use of resources. Municipal authorities are more effectively able to manage the assets on their territory. Property ownership must be properly balanced between central and local governments.
- *Delegate certain rights (with support from consultants) over management of specific government assets on municipal territory.* Water, forests, and infrastructure are important assets related to everyday municipal operation, the use of which municipal governments are currently unable to influence.
- Create an effective mechanism to estimate costs of municipal service delivery and accompanying charges. *Assign certain taxes to finance specific services.*
- *Create conditions for competition in the assignment of budget resources.* The experience of other countries argues for the delivery of many public services by nongovernmental organizations.

- *Delegate authority over the collection of local taxes and charges.* Bulgarian tax administration is a single structure subordinate to the Ministry of Finance. This creates conflicts of interest. If municipalities are to rely on revenue from ceded taxes and local charges, they should also have the necessary instruments to collect these payments.
- *Delegate greater authority and more opportunities to coordinate with a number of government services.* At present many services like labor offices, welfare services, and land commissions are under the authority of the central government and at the same time deal with municipal problems. Municipal administrations do not have any opportunities to influence these government services, despite the fact that most of the latter perform activities related to everyday municipal problems.
- *Improve coordination between local and central levels of government considerably* (particularly with regard to central-government-related initiatives that directly concern local government).
- *Seek lasting effects by investing in lasting projects.* Joint projects with neighbor municipalities, including municipalities from neighbor countries, offer specific opportunities to implement local policy (border regions, for example).
- *Provide direct access to EU pre-accession funds* and other international programs. In many cases the central government does not have adequate capacity to make full use of these funds, whereas programs open for municipal participation tend to be fully utilized.
- *Implement market mechanisms in the construction and maintenance of municipal infrastructure*, for example, by way of a state-initiated guarantee fund whereby municipalities gain access to financial resources and opportunities to build municipal infrastructure with a view to attract investments.
- *Discuss opportunities to set up a trilateral fiscal committee* with equal representation by the central government and municipalities. Such practice is found in many European countries. The basic objective of this committee is to provide coordinated state and municipal policy in the field of public service delivery.

Seventh, recommendations to local authorities to increase the role of economic policy generators are directed along two basic lines: first, to create conditions to encourage local business; and second, to improve public services that are part of the obligations of municipal authorities. Local economic development can be promoted in the first place through *local government support to entrepreneurs* targeting competitive development, as follows:

- Create entrepreneurial “*information shops*” and introduce the “one-stop shop” service to provide information on registration of economic subjects, permits, licenses, and other administrative acts required to start up a new business.

- Set up *municipal guarantee funds* for SMEs and use resources in these funds to cover a portion of the credit risk from bank loans. Cash proceeds from the privatization of municipal property could be a source of resources for these funds.
- Promote *aggressive marketing and advertising* on the part of municipalities in order to promote local businesses and attract foreign investors. Implement modern protocol practices in receiving foreign delegations as a way to attract foreign capital.
- Provide a well-functioning *industrial, research, and education base*.
- Develop *infrastructure* to secure an environment conducive to business development.
- Promote active social *dialogue* between local businesses, nongovernmental organizations, the unemployed, and the central government; it is valuable in overcoming labor market imbalances and identifying the optimum level of fiscal and government decentralization.
- Improve the *administrative capacity* of local authorities and harmonize administrative structures with European legislation.
- Assess *the effects of specific measures* and programs within the government economic and social policy and of municipal projects that encourage local employment.
- Develop education, qualification, and employment programs.
- Promote wide municipal participation in *EU pre-accession instrument projects*. Some projects to support local business are already operating—business incubators, infrastructure projects, development of local and environmental tourism, etc.

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# The Role of Local Government in Local Economic Development

Lithuania

*Algirdas Petkevicius*  
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### INTRODUCTION

The objective of this paper is to review local and regional development policies in Lithuania and explore the legal and economic instruments that the Lithuanian local and regional authorities possess in order to foster economic development on their territory.

Part 1 of this report reviews the political and economic circumstances that make the issue of local economic development central. The political reasons are explained for certain restrictions regarding instruments of local economic development as well. These restrictions relate to the changing administrative role of counties (regions) and the lack of administrative capacity in municipalities.

Part 2 investigates the legal role of local government in economic development. Major legal acts are reviewed; the territorial division of the country is outlined, and the tools of local economic development available to Lithuanian local governments are briefly described.

Part 3 lays out the policies that local governments declare in their planning documents. Lithuania's many local economic development plans include regional development plans, strategic activity plans, sector development plans, and others. These documents reflect what local governments think about economic development and which instruments they propose to use. Unfortunately, only large municipalities (primarily Vilnius) are able to offer innovative and far-reaching approaches at this stage.

Part 4 examines EU structural funds and the Single European Market—the key international factors influencing local economic development policy. The importance of structural funds should not be underestimated, as in the last couple of years the solutions to all major development problems—national, regional, and local—are associated with

EU structural funds. Thus the role that local governments are likely to play in managing these funds, as well as the amount local governments are likely to receive, are now of crucial importance to their development. No other public resources to address such issues are likely to be found. At the same time, exposure to increased competition on the European market may harm the least developed regions. The report then sets out a brief analysis of the theoretical assumptions on how local governments could respond to this challenge.

Part 5 presents major conclusions.

The key outcome of this report is a clear picture of what Lithuania has achieved over the last number of years in the field of strengthening the economic functions of local and regional authorities. While these achievements receive recognition, problems persist. The lack of well-qualified personnel at the local level is the primary reason that further economic decentralization or the extension of additional borrowing rights to the local and regional tier of government are unlikely. In general, few innovative approaches to development planning or management at the local level can be reported, except in Vilnius, where development perspectives are optimistic and the administration has successfully implemented far-reaching plans.

## 1. LOCAL ECONOMIC DEVELOPMENT IN LITHUANIA: POLITICAL AND ECONOMIC CIRCUMSTANCES

### 1.1 Economic and Political Factors in Local Economic Development

In Lithuania, local economic development policy is influenced by a number of attitudes that call for brief elaboration. These may be divided into the following categories:

1. The perception by decision-makers in the central government of the limited administrative capacity at the regional and municipal level.
2. The weakness of and frequent efforts to reform county (regional) government.

The administrative capacity of local governments in managing economic development is indeed limited, with the exception of urban municipalities such as Vilnius, Klaipeda, and Kaunas. As the civil service registry reveals, very few municipal or regional employees possess PhD degrees and comparatively few speak a foreign language. Salary levels at the municipal and regional level, fixed by the Civil Service Act, comparatively disfavor local and regional authorities, although the imbalance is decreasing. Still, for example, in accordance with a cabinet decree from July 10, 2002, the county governor is in the same category as the ministry's department director, while the deputy director

is equivalent to a ministerial head of unit with good standing. At the same time, central government institutions have better possibilities to offer incentives such as bonuses for excellent work or extra hours, commissions, training abroad, etc. This leaves municipal and regional units at a disadvantage and does not help build administrative capacity.

More important is the actual composition of municipal and regional employees. With the exception of large urban municipalities with many specialized administrative units (where highly competent personnel are employed), regional and municipal administrations usually have few administrative employees capable of performing tasks related to local economic development. Few employees are capable of negotiating with foreign investors or analyzing general economic affairs. While an administration may have a number of employees in charge of infrastructure development, legal affairs, etc., they tend to be occupied with routine tasks and are rarely capable of preparing strategic projects that require a non-traditional approach (such as projects related to EU structural funds). For example, Klaipeda county (relatively prosperous in terms of competence and resources) is structured in such a way (see chart 1 in full report) that only two departments—those of regional development and territory (spatial) planning—are directly concerned with issues of local economic development. Other departments such as village matters, social care, education, culture, and land management may influence the overall attractiveness of the territory for investment if complemented by similar efforts at the municipal level. However, many departments employ only one or two employees. In the case of Klaipeda county, the regional development department employs six people, and spatial planning and building supervision employs nine. However, Klaipeda county is a recipient of EU PHARE 2000 support packages and four out of six employees in the regional development unit are involved in monitoring. Other counties' regional development units also employ three to six people, but these employees are also charged with the task of spatial planning. All counties in Lithuania have similar units.

More prosperous municipalities such as Vilnius have advanced organizational structures and hundreds of employees who are relatively competent. In a given municipality, there are units in charge of economic development, real estate and privatization, tourism, urban development, cultural events, etc. Thus the possibilities for planning and implementing activities that may influence local economic development are good. This is, however, not the case in most rural municipalities.

Although the situation may vary from one municipality or county to another, the general perception by central government decision-makers is that most municipalities have little administrative capacity (which is perhaps true). Therefore, municipal and regional units usually have limited possibilities to influence central government decisions on the allocation of national investments. Suggestions from municipalities and counties tend to meet with resistance unless connected to a specific central government campaign. Local governments' borrowing rights tend to be restricted as well, as municipalities have proven that under a liberal regime they may borrow and spend without a strategic

approach. It sometimes dictates, too, the need for central government coordination between local and regional efforts if a viable result is to be achieved.

The fragility of regional government is another political issue surrounding local economic development. Lithuania is a comparatively small country (64,000 km<sup>2</sup>) with 60 municipal units. Coherent local economic policy at the municipal level is difficult to achieve due to the small size and large number of municipal units. Coordination of municipal activities at the central level has proven to be problematic; municipal initiatives aimed at territorial competition may be useful in terms of the efficiency of local service provision, but may be harmful to the country as a whole in terms of attracting investment—efforts by too many small municipal units are almost unseen. Thus, consolidated efforts at the regional level may be more attractive.

As a result of two factors—lack of administrative capacity and the weakness of county governments—possibilities for local and regional authorities to influence local economic development are naturally limited, even if, legally, they exist.

## 1.2 European Integration and Local Economic Development

Another factor that has a great impact on the role of local and regional authorities in local economic development is the process of European integration, primarily as it relates to regional development and coordination of structural instruments and the Single European Market.

In late 1990s Lithuania started preparation for the absorption of EU structural funds, and this led to public investment planning reform. County governments traditionally played a coordinating role in spatial planning and were tasked with coordinating regional development initiatives to produce regional development plans including not only the specific county-related affairs, but the general perspective of regional development, including municipal and central government realms. At the same time, the prospects of the Single European Market created discussions on its possible impact on both core and peripheral regions. Economists and policy makers have feared that the rules of the Single European Market may have huge negative consequences for peripheral, if not all, regions. Increased competition, the inability to use instruments of monetary and trade policy to protect national markets, and other factors contributed to the discussion of what both central government and municipal/regional authorities could do to remedy these projected consequences. It has been rightly expected that the response of local and regional authorities shall be the promotion of territorial competition—the creation of public-private partnerships that attract investment, and the search for innovative possibilities to boost local businesses. Indeed, in the framework of the Single European Market there should be and is expected to be an economic policy gap that the central government will not be able to fill. This gap is expected to be filled by local authorities.

## 2. THE ROLE OF LOCAL GOVERNMENTS AND LOCAL ECONOMIC DEVELOPMENT IN THE ECONOMY

### 2.1 General Overview of Local Government in Lithuania

Local self-government is organized on the basis of the administrative-territorial division of Lithuania. 60 municipalities constitute the lower level of local government, represented by municipal councils elected by the local population for a period of three years. There are ten regional administrations—county governments—which represent the deconcentrated power of the central government. County governors are appointed and dismissed by cabinet.

Unlike other Baltic countries, Lithuania does not suffer from a proliferation of small local governments. A vast majority of municipalities fall within the population range of 20–90,000.

In terms of financial resources, local governments are much more significant than county governments. They have autonomous budgets; the most significant source of revenue come from personal income tax and grants from the central government. Regional administrations are fully funded by the central government.

Every local government has an independent budget that it drafts and approves. Laws governing budgeting and taxation regulate the relationship between the state budget and local government budgets. In cases where local government institutions do not have adequate revenue to meet social needs, the state budget subsidizes local government budgets for the implementation of social programs.

Municipalities are, of course, an important actor in this respect, as they account for 34 percent of total government spending (excluding social security) and are the primary providers of education, public utilities (excluding electricity), and a variety of welfare programs and urban services. In the forecasted budget for fiscal year 2003, the central budget totals 9,545,160,000 litas (2.8 billion euro) while municipalities are expected to receive a fixed ratio of 45.78 percent of personal income tax (1,298,148,000 litas—2 billion in special central government grants and 47 million from the general grant).

Municipalities are responsible for a variety of capital intensive services such as water supply, sewage, and heating. Municipalities also finance construction and maintenance of roads and public buildings, including schools. Economically, municipalities essentially perform three major functions. First and most costly are primary and secondary education (55 percent of total expenditures and welfare benefits). Despite the fact that the central government directly finances pensions for the elderly and unemployment insurance, municipalities are also in charge of a number of benefits (mostly support to families) accounting for about 14 percent of total expenditures. The third field of spending is the so-called housing and communal economy, accounting for more than six percent. This

category encompasses the provision of public utilities and other infrastructure services (district heating, water supply, and sewage).

Since the municipal role in education is often limited to salary payment and maintenance of infrastructure, it may not be regarded as a tool of local economic development. The same can be said of social benefits. Issues of communal economy may, however, be attached to this category. In all cases, while Lithuanian municipalities are economically significant, both in terms of power and financial capacities, capital spending constitutes only a small part of total spending. In this respect, municipalities still strongly depend on the state.

## 2.2 Legal Regulation of Local Government Activity

This section will review the legal tools available to Lithuanian local governments in the field of local economic development.

*The Local Self-Government Act* divides municipal functions into four categories (independent functions, authorized functions, delegated functions, and contracted functions) and enumerates several directly linked to economic activity. Independent functions include training and re-training the labor force, tourism development, and business promotion; authorized functions include infrastructure planning, social and economic development, drafting SME development and tourism development programs, and participating in the implementation of regional development programs; delegated functions include planning and implementing measures for labor market policy and resident employability. The Local Self-Government Act describes several ways that municipalities can become involved in local economic development: comprehensive and sector development planning, room to implement specifically designed development programs and sector-related activities.

*The County Government Act* specifies, in a similar way, the economically significant functions of county governors. It indicates that governors are entitled to implement policy in the fields of regional development, spatial planning, and land use, as well as governmental and interregional programs. Governors also draft county development programs and coordinate the activities of municipal institutions in implementing regional programs. County governors also coordinate and implement regional rural development programs.

*The State and Municipal Property Administration, Use, and Disposal Act*, along with *the State and Municipal Company Act* are important legal documents addressing establishment and lease of municipal companies—the most considerable pillar of municipal economies. Municipalities may establish and own municipal companies or act as founders or managers of other types of companies. *The State and Municipal Property Privatization Act* states conditions for privatizing municipal economic facilities. The key provisions of this legislation define the possibility to privatize or (temporarily) transfer municipal

property. Privatization must, however, be ultimately approved by the central government, and the temporary transfer of property (including all forms of lease of facilities) is conditional on two factors: i) the transfer must ensure that the municipal function will be implemented by the lessee; ii) after the term of lease ends, the municipal company or institution must ensure that the property is returned.

*The Regional Development Act* complements the function of county governments (and to some extent municipalities) by adding a component of their participation in implementing national regional development policy. The act stipulates that the priorities of regional development are to be discussed by a regional development council composed of the county governor, local mayors, and delegated representatives of respective municipal councils. While the Regional Development Act specifies official objectives and tools of regional policy (reduction of disparities between regions, promotion of market economy in each region, etc.) and requires each region to produce its own regional development plan in accordance with established methodology, these exercises have a minimum impact on investment allocation. Provisions of regional development plans may have material implications only to the extent that they are taken into consideration in other (national) documents, primarily the single programming document for EU structural funds. This is, however, rarely the case.

Overall, the economically significant functions of Lithuanian local and regional authorities may be summarized in the table below:

*Table 1.*

The Roles of Local and Regional Authorities in Economic Development

Sector of Activity	Municipality	County
Business development and attracting investment	Drafts SME development programs; licenses and registers businesses; prepares spatial plans; administers use and disposal of municipal property; manages communal economy.	Performs spatial planning, prepares regional business development programs; supervises implementation of the Agricultural Companies Act; administers government land not transferred to municipalities.
Transport	Plans and develops municipal transport infrastructure.	Develops regional transport infrastructure.
Tourism and recreation	Assures public order; organizes tourism and recreation; drafts tourism development programs and public transport.	Implements rural development programs (including rural tourism); protects cultural heritage.
Rural development and rural tourism	Functions may primarily relate to tourism development in general.	Implements rural development programs.
Vocational training and human resource development	Provides education and vocational training for adults and youth; organizes employment (public works); supports social integration for handicapped people	Establishes and operates regional educational institutions; contributes to creating employment.

## 2.3 Summary of the Tools for Local Economic Development

Lithuanian counties do not have fiscal autonomy and carry out quite a limited range of economic functions, while local governments (municipalities) do have autonomous budgets, but within these budgets only 1 to 5 percent of the funds (depending on the municipality) may be earmarked for purposes other than salary payments, social payments, education, maintenance of mandatory facilities, and communal economic services. This makes Lithuanian counties and municipalities greatly dependent on external sources of funding—either from the central government or international donors, but primarily the EU. On the other hand, this shifts emphasis from policy instruments that could be implemented by means of material allocations (such as infrastructure development) to instruments that do not require material allocations (attracting investment via local marketing efforts, improvement of local administrative culture and services to investors and entrepreneurs, attracting investment in communal economic facilities, and—very importantly—attracting EU structural funds and other donor resources). Roles and tools, then, are as follows:

- Attract investment.
- Improve local administrative culture.
- Attract investment in communal economy facilities.
- Attract donor aid, primarily EU structural aid.

These tools are analyzed in greater detail in the full report.

## 3. PLANNING FOR LOCAL ECONOMIC DEVELOPMENT

In this section, actions and programs described in strategic planning documents will be analyzed and compared. If even some have never been (or are not yet) implemented, they suggest what municipalities perceive as realistic. In many cases these “planning solutions” are declarative and not supported by resources, but analysis shows that some municipalities may be quite creative in planning their future.

“Planning solutions” in urban municipalities (i.e. “core” municipalities or “growth poles”) and other (predominantly rural, but possibly also tourism- or recreation-oriented) municipalities were analyzed separately. Examples of the first category are the urban municipalities of Vilnius, Klaipeda, and Siauliai, and examples of the second category are the municipalities of Ignalina, Vilkaviskis, and Palanga. To complement the spectrum of planning documents, the achievements and problems of regional development planning at the county level has been discussed, using the example of Marijampole County.



Besides intending to show the difference between “reality” and “plans,” this analysis points out the difference in the approach to local economic development taken by several urban and rural municipalities and by a selected county government. The creative approach shown by the urban municipality of Vilnius goes as far as creating knowledge parks, building highways, and preparing green fields and brown fields for potential investors, while the approach taken by most municipalities is limited in scope, despite the fact that the structure of development-related spending is similar everywhere—i.e. most funds are earmarked for educational needs and social benefits. Analysis reveals that some of the Lithuanian municipalities have a significant potential for innovation toward local development by improving local services for investors, improving local infrastructure, and accumulating funds by efficiently privatizing public property, while others confine themselves to a limited role and limited range of development tools even when planning for the future.

The key presumption in selecting background material for this section was the fact that actions aimed at continuous progress in local development have to be based on a viable multi-year perspective, rather than on single actions.

Several trends may be identified in Lithuanian municipalities and counties:

1. Municipalities have more financial and legal possibilities to influence local economic development results than counties. Some use innovative approaches to long term development. Even when municipalities’ own material resources are limited, substantial progress may be achieved by attracting investment or creating a culture of quality administrative services, as was done in Vilnius.
2. While some municipalities search for innovative actions and aim to attract investment (Vilnius, Klaipeda) many others are limiting the scope of their activities to single actions. This may be (but is not necessarily) justified by local conditions and the size of the local budget (Ignalina, Vilkaviskis, Palanga).
3. Some municipalities and counties tend to create development perspectives almost exclusively based on the presumption that external funding (primarily from EU structural funds) shall be available. These presumptions may hardly be realistic and rather more political than economic in nature, but they are characteristic of almost all municipalities and counties reviewed, except Vilnius, Klaipeda, and some others.
4. Most municipal and county plans contain declarative elements and propose analysis or assessments instead of action. This reflects the fact that the majority of municipalities have not assessed performance in many sectors of their local economy and do not yet have a clear strategic vision. Within the municipalities reviewed, this trend is characteristic of all except Vilnius.

## 4. NEW CHALLENGES AND OPPORTUNITIES

This section briefly reviews the influence of European integration on the role of municipalities and regions in local economic development, with particular emphasis on EU structural funds and the Single European Market. This section demonstrates how integration promotes the role of local authorities and what problems arise during the process. Local governments are expected to perform a number of tasks in local economic development related to European integration, and central government institutions are interested in promoting this role.

### *EU Structural Funds*

EU structural funds are financial tools for candidate countries to ease accession. The key aspect of these instruments is that they are expected to contribute to reducing the social and economic disparities between EU regions by strengthening infrastructure, promoting business development, training human resources, and providing other specifically designed assistance. These resources are significant compared with those currently available. For 2003 alone, approximately 100 million euro of non-returnable aid was received by Lithuania for purposes of rural development, environmental and transport infrastructure, and human resource and business development—approximately 10-15 percent of the national investment budget. After accession, annual allocations were to reach 300-400 million euro (concrete figures are negotiated), making this source of public investment the most significant share of available resources. As a result, the role local and regional authorities are expected to play in managing these resources is directly related to their role in local economic development—one of the most significant and challenging tasks they perform in this field.

Indeed, the local and regional dimension in investment planning and management is not as strong as desired. Lack of administrative capacity and insufficient legal competencies for regional and local institutions make it impossible to entrust them with major managerial functions or decision-making powers that could considerably affect state budget allocations. However, it is acknowledged that the regional and local level must always be consulted. Still, the primary role of the local level in absorbing these funds is attributed to the preparation and implementation of specific projects that fall under the local administrative realm and are eligible for funding.

Several relevant lessons can be drawn from the pre-accession period:

- First, as the experience with pre-accession assistance shows, there is still a lack of well-prepared projects from regional or municipal units that could be financed from EU funds. This problem is accompanied by the issue of integrated investment planning and management, as projects should be either coherent sectoral development strategies or local/regional development plans, while there is an

apparent lack of well prepared and approved regional or local development strategies at this stage (see previous section for an overview of some of these strategies).

- Second, EU funds require adherence to the principle of additionality—the need for counties or municipalities to provide their own resources in implementing project(s). Thus the national (state or municipal) budget is expected to contribute to project financing, and in cases when a municipality or county is legally in charge of some activity eligible for EU aid, a respective project is expected not only to be prepared, but also co-funded by a respective territorial unit. Here two aspects are of high importance:
  - Municipalities have limited resources to finance capital projects, as less than 4 percent of their own resources are used to finance capital investment, and resources that may be earmarked for business development or human resource development are not considerable.
  - Municipal borrowing, which could offset the lack of funds for co-financing EU projects, is strictly regulated by the central government in order to prevent excess.

Hence the following conclusions:

1. EU structural funds will provide badly needed resources for municipal and regional investment initiatives, although these resources shall be conditional on the presence of sufficient administrative capacities and suitable project initiatives.
2. EU structural funds inevitably change the structure of public spending. The fact that 400 million euro is available in the form of non-returnable aid that must be co-financed presumes that very little national funds, except those earmarked for non-developmental needs, can be left outside of this framework. Thus municipalities that are not ready for the absorption of the funds may *de facto* lose some share of already available annual resources (primarily those from the state investment program, which addresses capital investment needs).
3. The role of local and regional authorities in absorbing EU structural funds shall be focused on programming (provision of information and support in building partnerships), project preparation, and, to some extent, management.

It is important to note that EU funds cannot be efficiently absorbed without municipal participation, because the central government is not legally entitled to initiate or implement projects in the municipal sphere. The municipal sphere includes too many socially significant functions (education, energy, water and other infrastructure facilities) that cannot be ignored. Thus foreseeing problems with local administrative capacity, the central government may try to initiate various technical aid schemes and

campaigns to help local authorities initiate and develop projects. Indeed, only those local governments that use these new opportunities will really perform their economic function well.

A general recommendation is formulated for municipalities to pay more attention to structural funds. At the same, little can be said to those rural municipalities that clearly lack administrative capacity. There is no clear way for them to attract qualified personnel for project preparation and management, and thus they must rely on private consultants. What the central government can do is prevent consultancy enterprises without proper credentials from entering the market and misleading disadvantaged municipalities.

### *The Single European Market*

The Single European Market is another factor influencing local economic development. Participation in the market requires the elimination of all internal barriers regarding the flow of goods and services, thus exposing national producers to increased competition from the more efficient enterprises in more highly developed EU member states.

There is some question as to whether the Single European Market benefits prosperous “core” regions, lagging regions, or neither. While most scholars and officials presume that lagging regional economies will be hit severely by increased competition, some think EU structural funds, common agricultural policy, and long-term economic benefits will rectify temporary losses.

According to Cheshire (1991), core regions will gain, but small industrial cities and agricultural towns will lose, mainly because a lot of unskilled labor will remain there. At the same time, “agricultural protection, via the system of supported prices, gives most assistance to the most productive farmers.” In the early 1990s, many academics were skeptical about the impact of the Single European Market on lagging regions. They criticized the findings of the Cechini report published in 1988, which they claimed was based on purely neo-classical assumptions and presumed that a common single market, characterized by equal market access, would lead to a further increase in efficiency. It was thought, for example, that “the general assumption appears to be that additional prosperity will be fairly evenly distributed throughout the regions of the Union. Moreover, the report claims that regions which have hitherto been disadvantaged will profit more from the SEM project than from the already well established regions of Europe.”

Although European institutions have always been more optimistic, some skepticism is still seen within Lithuanian policy circles. The key question remains what the central government and local authorities should do to soften possible negative consequences. Of course, EU structural funds are one answer—the central government may assist local authorities prepare and manage quality projects aimed at business or increasing the attractiveness of the territory for investment, thereby offsetting a part of the possible

economic consequences of the SEM. Another suggestion could be for the rural local governments to create efficient public-private partnerships to discuss local economic policy directions and adopt common solutions. These schemes are known to work in the West, as they are able to make municipal economic policy more efficient, local efforts more consolidated, and the needs of local enterprise apparent.

## 5. CONCLUSIONS AND POLICY RECOMMENDATIONS

Based on a review of the political limitations on local economic action, the legal tools and planning practices available to local government, as well as the influence of international factors, the following recommendations can be made:

1. Local governments need more training and incentives to design and implement active local economic development policies. Incentives for employees in local administrations may be considered particularly important and should attract more qualified personnel. Setting up nongovernmental organizations such as business information centers, funded by the government but benefiting from project profits, can also be an important step towards improving local capacity. This could help partly overcome the problem of administrative capacity and contribute to project preparation for EU funds.
2. Municipalities and counties should change their approach to drafting regional development strategies or strategic action plans. The ones that now exist are not innovative in any sense (with a few exceptions) and demonstrate the inability of local administrations to establish coherent prospective policies. Most rural municipalities cannot overcome this problem due to lack of capacity. They often must rely on external expertise, but specialists frequently cheat their clients, producing routine and often useless strategic documents. Central government institutions should provide advice to the local administration on defining adequate standards in this field. The innovative approach of Vilnius municipality should be encouraged, but such a broad approach is likely to remain rare.
3. All local units should take an immediate interest in EU structural funds as a major source of future investment, as well as in creating/promoting local partnerships with active NGOs and enterprises, in order to make local economic policy better and more efficient. Here, however, the central government is expected to assist poor municipalities, as they cannot be expected to manage alone.

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# Territorial Self-Government and Local Economic Development

Poland

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### 1. LOCAL GOVERNMENT IN POLAND—BASIC FACTS

During the communist period, local authorities were said to represent both local communities and state interests. Local administration was subordinated both to citizens' councils, elected in (theoretically) general elections, and to a higher level of the administration. Citizens' councils themselves formed a pyramid of hierarchical dependence topped by the state citizens' council, which had executive powers over all lower-level councils. The regime repressed individual initiative and autonomous actions. Society was organized around place of work, not of residence. Management of enterprises and official trade unions would distribute privileges, apartments, car vouchers, and make decisions on people's careers. Neighborly cooperation was seldom encountered.

As emphasized by Regulski (1997), self-government reform in 1990 broke five state monopolies:

- the communist party's political monopoly
- the monopoly of unified state power
- the monopoly of centralized state power
- the monopoly of public finance
- the monopoly of public administration.

Now, the competencies of territorial self-government in Poland are broad but asymmetrically distributed among the tiers. Regional authorities do not play a major role in promoting local development or direct provision of services. It is thus understandable that they were not provided with many policy instruments. However, decentralization must still address the huge asymmetry in financial and administrative power favoring municipalities over regions.

*Table 1.*  
Municipal and County Competencies

Issue / field	Municipality	County
Budget revenues	High revenue, in large part coming from local taxes and share in income taxes	Low revenue, almost exclusively based on transfers from the central budget
Tax incentives	Broad competencies on local tax rates and relief, but with limited impact on big investors	No competencies
Development of technical infrastructure	Broad competencies with possibility of applying for assistance funds	Broad competencies, possibility of applying for assistance funds, but limited capability of own contribution
Strategic planning	Strategic planning for development (not compulsory) and spatial planning (compulsory)	Competencies too low for meaningful strategic planning, however some counties make attempts
Developing business assistance institutions	Broad competencies limited by financial restrictions	Similar to municipalities but with substantially lower funds
Foreign cooperation	Frequent sister-city and similar agreements; most cases related to culture and student exchange	Not yet well developed. Attempts to solve labor market problems by searching for job offers abroad.
Municipality/county promotion	Broad competencies limited only by availability of funds	Broad competencies limited by availability of funds and ability to cooperate with municipalities within the area

## 2. EXOGENOUS FACTORS OF LOCAL DEVELOPMENT IN POLAND

The development potential of territorial self-governmental units is to a great extent dependent on external conditions in which a particular unit functions. In the past (the 1960s or 1970s) this relationship was very close—mainly determined by the location of a given area in relation to the sources of raw materials and markets. Three well-known factors determined the development opportunities for a given area—location, location, location. In recent decades, the location factor has lost some of its significance in favor of communication links, local quality of life, human capital, security, level of education, etc. It is in those spheres that local governments can undertake efforts intended to increase an area's attractiveness for investors. However, external conditions still play a significant role in the development of local economies. According to Gorzelak (1998), three major questions tend to determine levels of municipal development in Poland:

- Before 1918, was the area under the rule of Russia, Prussia, or Austria?

The regional disparities in Poland's development potential date back to the period of partition (1795–1918), when today's Poland was subject to the rule of neighboring countries. In the 19<sup>th</sup> century, a critical period of economic and administrative development in Europe, the three ruling countries greatly differed in terms of pace of reform, introduction of civil liberties, and the scale of investments in infrastructure. Highest levels of socioeconomic development took place under Prussia, where feudalism was banned as early as 1807, and the institution of municipal self-government was established in 1808. The pace of development was slowest in the part of Poland under Russian rule, where feudalism was not outlawed until 1861. Regional disparities today reflect the former boundaries of the partition period surprisingly accurately.

- Is the area rural or urban?

Rural areas in Poland are not as well developed as towns in terms of physical infrastructure, human capital, and the labor market. One-crop agriculture is a serious problem in many rural areas. Despite dynamic development in traditional and modern services, more than 20 percent of the population earn their living from agriculture. EU integration involves the need to move a large part of the population to non-farming occupations. This means rural areas are seriously endangered by increased unemployment, which already exceeded 18 percent in 2002.

Over the past 12 years, many rural municipal governments focused on constructing municipal water, sewage, and telephone networks, waste treatment plants and solid waste landfill sites. In addition, most municipalities aspired to stimulate enterprise and create opportunities for education and employment for their residents.

- How far is the area from a metropolitan center?

Areas located within a city's outer ring experience an inflow of investment, high revenue from local taxes, and broad employment and development opportunities. However, municipalities lying at a greater distance may be increasingly ignored due to their lack of the above. This has led to an increase in urbanization, further harming the economic situation of the periphery. Over time, "rings of poverty" appear around a metropolis, showing how far the cities magnetism and real benefits reach.

### 3. TERRITORIAL SELF-GOVERNMENT AND LOCAL ECONOMIC DEVELOPMENT

This section discusses selected activities undertaken by local governments that have a direct impact on local economic development processes. In particular, the role of local

leaders—the driving force behind every local government success—is highlighted, along with the role and motivations related to strategic development planning, typology of fiscal and investment policy of local governments, different approaches to tasks taken over from central administration, abilities of local governments to promote innovation and attract external investors, propensity for corruption, and the relationship between the size of an area and local government effectiveness.

### 3.1 The Role of Local Leaders in Economic Development

Leaders are of great significance for the success of the local government. In the case of many Polish municipalities seen as successful, leaders played a decisive role. Particularly in smaller areas, the leader is also the key author of the development vision for a given area, a person who integrates local elites and plays an important role in securing funds for the pursuit of strategic goals.

After the fall of communism and the first free local government election in 1990, the question of ideological identity emerged among newly elected local leaders. Leaders may be divided into three groups based on their levels of experience. The first includes persons previously uninvolved in public service, for whom the re-institution of territorial self-government provided a first opportunity to make use of their leadership talents and fulfill their vision of the local community, etc. The second group brings together leaders who had emotional ties with the former democratic opposition and who, until then, had had no possibility to participate in any open public activity. Finally, the third group includes leaders who had links with the former central administration, and who sought to continue their careers under the new political circumstances.

One of the most striking examples illustrating the crucial role of the leader in local development is the story of Terespol municipality on the Belarusian border (see Dziemi-anowicz 2002). From 1990 to 1992, Terespol was a mixed urban-rural municipality, which meant its area comprised the town of Terespol and the surrounding area. The mayor strived to make use of the municipality's border location in order to stimulate sustainable development. He planned infrastructure investments (water, sewage, and telephone networks) in rural areas in order to improve quality of life. However, his initiatives met with resistance from councilors representing the urban part of the municipality, who opposed costly investments in rural areas and did not believe in basing the municipality's operations on an independent development vision. Instead, they preferred to wait for state support before improving the local socioeconomic situation.

In 1992, this conflict led to the division of the municipality into two parts. The former mayor held his position in the rural area. The rural municipality based its development on investments into technical infrastructure and utilization of border-related facilities located in its territory: the TIR customs clearance point, the railway

reloading station, and a free customs area. Meanwhile, local urban leaders saw their only development opportunity in preserving petty border trade, which remains a basic or additional source of maintenance for about a third of the population. However, in view of Poland's accession to the EU, this approach proved unrealistic. As one councilor put it before accession, "Once visas are introduced for Belarusians, we'll probably have to plough Terespol up."

The role of leadership (or lack thereof) in local development is well illustrated by the results of local government elections in two neighboring localities. Since the establishment of the independent rural municipality, its leader was elected *wójt* (mayor) three times in a row. In the election of 2002 he received 81 percent of the vote, meaning an uninterrupted mandate of 11 years. At the same time, in the neighboring *town* of Terespol, no mayor has held office more than two years (half the official term). In recent elections, no candidates won more than 35 percent of the vote.

Terespol seems to be a model example of the critical importance of leadership in the success of territorial self-government. Moreover, it confirms yet again that the presence and vision of a leader can play a crucial part even when a given area is affected considerably by external factors, as is usually the case with a border region.

### 3.2 Planning for Economic Development

Local government planning documents vary widely. Sometimes the quality of their content is very high. At other times no planning can be found in the document at all. There seem to be three common approaches:

- A long-term approach assumes the strategy should identify development policies and ways of attaining the goals over a period longer than local authorities' current term of office.
- A "magical" approach assumes the strategy itself will prove a panacea for the problems of a given community.
- A pragmatic approach arises from the conviction that elaboration of a strategy will boost chances of obtaining external financial support for the implementation of long-needed investments.

The latter two styles are quite dangerous to local development. Sometimes local leaders develop a conviction that a strategic plan of development is a document commissioned by experts disconnected from the locality in question, and as a commissioned product, should be elaborated with minimum effort. This belief is exacerbated by the many consultants who offer to write a strategic document in as little time and with as little effort as possible. Frequently, the outcome of such activity is a document in a vacuum—a strategy that no one identifies with, which will never be put into practice.

The pragmatic approach is frequently a side effect of policy pursued by institutions supporting local government. Since the early 1990s, public funds from the budgets of the EU, USAID, the British Know-How Fund, and other sources were allocated to local governments. A document defining development strategy is often a pre-condition for obtaining such grants or loans. Therefore, the possibility of raising funds may often become a reason for securing something at least resembling a strategic planning document, without any genuine intention of engaging resources in developing a truly far-reaching strategy not governed by current needs.

### 3.3 Local Fiscal Policy<sup>1</sup>

Fiscal policy, both at the central and local government levels, is a particularly telling example of the impact decision-makers can have on economic development. First, this sphere is subject to exceptionally strong control by citizens, who are directly affected by fiscal and transfer policies. Second, citizens often put forth contradictory proposals—simultaneously calling for lower taxes and increased expenditure. In this context, the attitude of local leaders is extremely important; they can strike a compromise between desires or implement municipal policy on their own.

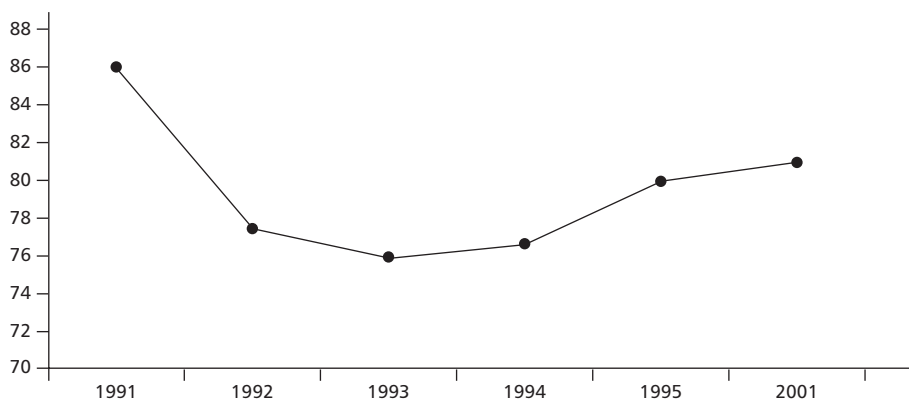
The most explicit example of fiscal policy implemented by a local government is the local tax rate. Maximum rates are determined each year by the Ministry of Finance, but municipalities may follow their own policies below the pre-determined threshold.

Swianiewicz's analysis (1996), supported by additional calculations using more recent data, allows observation of an interesting regularity in the fiscal policy of municipal governments from 1991 to 2001. Initially, municipalities, lacking orientation as to actual revenues and unavoidable spending, adopted tax rates near the maximum values. In 1991, an average rate for six local taxes in relation to the maximum was approximately 86 percent. Over two years this value fell to about 77 percent, and afterwards began to rise, exceeding 80 percent in 2001.

Analyzing the data from the first half of the 1990s, Swianiewicz comes to the conclusion that effective property tax rates were clearly higher in urban municipalities, particularly in large cities. Two equiponderant interpretations of this fact can be made. The first (populist) states that social pressure exerted on municipal bureaucrats to reduce tax rates was greater in smaller localities. The second (substitutive) interpretation states that the relatively high tax rates in large cities are due to the deficient system of calculating payments under this tax. The amount of tax depends solely on the amount of real estate, not on its actual value. Higher rates in towns, which are particularly attractive business locations, make up for the potential revenues that the local government would obtain from the ad valorem tax. The calculations based on data from 2001 invite the conclusion that the observations made by Swianiewicz still stand.



*Figure 1.*  
Tax Rates as a Percentage of Maximum Rate  
(Average for the Six Rates Analyzed<sup>2</sup>—Average Value for All Municipalities)



*Source:* Swianiewicz 1996, author's calculations.

Although towns normally set tax rates higher than rural municipalities, effective rates for enterprises and individuals are similar. Businesses operating in towns and cities suffer heavier property tax burdens (in relation to the maximum rates) than individuals. However, when we take into account all local taxes, the tax burden for natural persons (individuals) is higher. In rural municipalities, where taxes are usually lower, different policies towards individuals and businesses are easily visible. In rural areas, the average effective tax rate for real estate owned by individuals represented only 63 percent of the statutory maximum rate, and for real estate owned by corporate persons—nearly 86 percent. This means that reduced tax rates in rural municipalities are social, or—as Swianiewicz claims—populist in nature. There is little to indicate that towns regard high property tax rates on enterprises as a substitute for *ad valorem* tax. In such a case, diverse fiscal policies should be expected in relation to individual taxpayer groups. Referring once more to Swianiewicz's 1996 work, we would like to recall his classification of fiscal policies of the Polish municipalities. It is shown in Table 2.

According to this research, the populist approach is most frequently encountered rural municipalities. Stimulation policies turn out to be unrelated to the size of a municipality, probably depending on the size of the personality of the leader and their vision of municipal development. The fiscal approach occurs more frequently in towns than in villages, whereas authorities in small municipalities tend more frequently to implement liberal policies.

*Table 2.*  
Types of Fiscal Policies of Local Governments (According to Swianiewicz)

		Taxes on Business Activity	
		low	high
Taxes paid by most residents	low	liberal	populist
	high	stimulating	fiscal

Source: Swianiewicz (1996).

### 3.4 Local Investment Policy

In the course of work on regional and local development strategies, two problems appear that relate to the manner of spending. The first relates to spatial concentration of investments. Sustainable development policy is frequently understood as policy intended to support all areas of a given municipality or region. Social groups from underdeveloped areas try to exert pressure on local politicians to weaken the impact of polarization. The second problem is also related to the concentration of funds—policy makers must choose to promote either social or economic investments.

Dziemianowicz et al (2000), in research involving a representative sample of 28 municipalities, obtained information concerning the direction of investments aimed at improving business conditions. Municipalities were surveyed about investments completed between 1997 and 1999, during the research period (2000), as well as those planned up to 2005. For every time interval, most municipalities listed investments in water and sewage infrastructure (including sewage treatment plants), followed by investments in roads and pavement.

The distribution of these responses between urban municipalities and rural municipalities was unsurprising. Responses indicated that water and sewage infrastructure will be developed in every second town with a population over 50,000 and in every second rural municipality. On the other hand, 50 percent of towns with a population over 100,000 and 44 percent of towns with a population between 50,000 and 100,000 intended to invest in roads. The fact that only every tenth rural municipality intends to build and modernize roads and pavements in the near future shows that those territorial units will primarily focus on the fulfillment of basic needs such as water and sewage.

Swianiewicz discerns four distinct investment approaches:

- *Municipality as “growth machine”* (24 percent). In this approach, investments are regarded as a measure of influencing the local economy and focus on initiatives and ventures that are particularly important for potential investors and remove barriers impeding further development.

- *Living standards* (52 percent). Immediate fulfillment of residents' needs is the main motive for action.
- *Grassroots* (8 percent). A populist approach, in which the authorities are responding to demands voiced by voters.
- *No priorities* (16 percent).

The author highlights the marked interdependence between levels of investment and wealth. He also points out that the behavior of Polish municipalities defies Peterson's theory of *city limits*, which states that competitive pressure forces all units to undertake investments that foster development, while only those municipalities which can afford it invest in spheres related to the redistribution of goods. In Poland, it is mainly opulent municipalities that invest in infrastructure (roads, telephones, and sewage), whereas the relationship between wealth and redistribution remains unclear.

### 3.5 Promoting Entrepreneurship by Territorial Self-Government

Initiatives aimed at promoting enterprise are seldom elements of a separate document referred to as the program. Frequently, enterprise promotion is a component of development strategy, or, alternatively, a separate development strategy is elaborated, e.g. for the SME sector.<sup>3</sup> The components of such documents frequently refer to research on the subject (e.g. Blakely 1994, VanHoove 1999). Activities intended to improve the situation of local entrepreneurs include:

- support for "one-visit" centers and business support centers
- creation of and support for business incubators, technology parks, and industrial zones
- support for local and regional development agencies, which adopted an initiating role in raising funds for business support during transition
- support for initiatives intended to improve the qualifications of the local labor force.

In 2001, there were 142 training and advisory centers in Poland, 20 centers for technology and information transfer, 57 local loan and guarantee funds, 44 business incubators and technology centers, and 3 technology parks (Matusiak 2001). In addition, there were 14 special economic zones (the majority of which spread across at least two municipalities).

Interestingly, as a key factor in successful innovation and entrepreneurship, researchers tend to list the "local [business] climate and involvement of local authorities," followed by such factors as participation in governmental and foreign programs supporting such units, the range of services provided, responsiveness to market expectations, etc. (Matu-

siak 2001). Such an assessment unequivocally proves that local authorities get involved in supporting business-environment institutions to a great extent.

Local authorities in Poland support such institutions through buyout of shares, making facilities owned by municipalities available, providing financial support, and exemption from local taxes. The 2000 study (Dziemianowicz et al.) revealed the following interdependencies:

- Business incubators, business support centers, etc. are supported by offering access to facilities (33.3 percent of municipalities) as well as financial assistance (33.3 percent).
- Development agencies are supported by contributing shares to the agency (58.3 percent of municipalities).
- Advisory and training centers are supported mainly by direct co-financing (70 percent) or by making facilities available (40 percent). Financial assistance is also the main instrument in supporting loan and guarantee funds (50 percent). Every fourth municipality contributes shares to those funds.

Large cities are characterized by their higher involvement in supporting these institutions (Table 3). The situation is much worse in rural municipalities, where local authorities only engage in a minimum amount of institution building.

*Table 3.*  
Percentage of Municipalities Creating Pro-business Institutions

	Total	Towns			Rural Areas
		Population over 100,000	Between 50,000 and 100,000	Under 50,000	
Business incubators and business support centers	26.4	43.3	33.3	19.1	4.8
Local development agencies and local initiative agencies	26.4	50.0	50.0	8.5	4.8
Advisory and training centers	13.6	33.3	11.1	6.4	0.0
Guarantee and loan funds	10.0	93.3	0.0	10.6	0.0

Source: Dziemianowicz et al (2000).

The barriers obstructing the promotion of entrepreneurship by municipalities may be divided into three categories:

- *External barriers* usually include the complicated tax system, high taxes, the economic weakness of the region, and an unfavorable location with regard to main economic partners.

- *Internal barriers existing within companies* include a small propensity for investment.
- *Internal barriers existing within municipalities* include high unemployment, unfavorable unemployment structure, small absorption of the local market, and limited own funds of the municipalities.

### 3.6 Attracting Foreign Investors by Local Governments

An analysis of the location factors of foreign investments at the local level leads to the following conclusions:

- In the first half of the 1990s, the *location* of the Polish partner in a given municipality was the crucial factor for foreign capital (Buszkowski, Garlicki 1996). This means that foreign investors mainly took into account the attractiveness of the enterprise they were buying, and not the business conditions that were created by the authorities at various levels.
- By 2000, the location factor fell to sixth position on the list of factors. It can be said that this was the result of a natural depletion of the pool of Polish companies that were attractive to foreign capital as privatization progressed and Poland opened to investment.
- Nonetheless, many factors do not depend on local authorities (Figure 8). Technical infrastructure is the factor that most matters to foreign investors and still depends on local authorities and their activities. Unfortunately, local authorities tend to forget that what foreign investors are most interested in is the provision of technical infrastructure in the real estate they intend to buy, and not the overall figures concerning the municipality's water and sewage systems.

The limited potential of local authorities to attract foreign capital is also confirmed by cyclical research concerning the attractiveness of Polish towns for investors (Swianiewicz 2000). An analysis of over 70 indicators describing ability to attract investment leads to the following conclusions:

- Attractiveness largely depends on the size of a town. Large urban centers offer investors the best transport solutions (primarily airports), highly qualified labor, modern office space, a market, and proximity to suppliers.
- In the case of smaller towns, the most attractive are located in the vicinity of Polish cities (Warsaw, Poznań). Frequently, these small urban centers are situated within agglomeration limits. Their attractiveness is an outcome of a combination of several factors. Due to the proximity to the core agglomeration, foreign investors may use the pool of qualified labor and treat the entire agglomeration

as one important market in terms of sales and supplies. In addition, small urban centers compete with large cities in terms of taxes and real estate prices. For this reason, we can observe the phenomenon of transferring production activity from the core agglomeration to the outskirts, while the company headquarters and offices remain in the centers of the largest cities.

- Generally, ability to attract investors diminishes with increasing distance from the western border. This does not mean that there are no towns in the east which are attractive for investors, but many centers are located closer to the country's western border. This is largely due to western regions' extensive trade contacts with Germany, as well as the better condition of technical infrastructure there.

### 3.7 Transparency and Corruption

The quality of local government is an important factor helps attract external funds (discussed above). Transparency is key to quality. The more transparent the operations of local authorities are, the lesser the probability of corruption and other pathological phenomena obstructing local development. Many reports on corruption indicate that, at the local government level, corruption is most frequently encountered in the following cases (World Bank 1999):

- transactions related to real estate lease and privatization
- issue of building permits
- public procurement procedures for the provision of specific services
- flat allotments.

Although this paper does not strive to examine the reasons for corruption or for the dishonesty of local bureaucrats, it should be pointed out that many problems are caused by unclear, ambiguous regulations.

The type of problem that foreign investors most often cite relates to “matters arising from the ambiguity of regulations.” Corruption is listed in fifth place (meaning 15 percent of responses—see Table 4).

Problems relating to the dishonesty of local authorities are not distributed evenly across the country. An analysis of the opinions voiced by entrepreneurs and residents settling their matters in municipal offices shows that investors are more likely to complain of corruption in large cities rather than rural areas, and in the east rather than the west (Swianiewicz et al 2000):

Regions that have more developed local media and social organizations, which more frequently enter into municipal unions, and whose authorities more frequently establish international contacts, enjoy a better situation as far as corruption is concerned.

However, given the availability of regional data, it is hard to prove unambiguously that poverty is the main reason for bribery.

*Table 4.*

Commonly Cited Matters That Foreign Investors Cannot Settle in Municipal Offices

	Percent of Responses
Matters due to the ambiguity of regulations	34.5
Streamlining cooperation with tax offices	23.6
Bureaucrats missing deadlines	22.5
Customs matters	15.6
Corruption	15.5

*Source:* Błuszkowski, Garlicki 2000.

## 4. RECOMMENDATIONS

*(referring to full report)*

The following general recommendations come directly from the detailed analysis included in the preceding chapters. Here we only recall the major findings in a more organized framework.

Subsidiarity is the key feature of Polish decentralization reform and it should remain the leading concept of future policy. The central government and Parliament should focus on enhancing the legal framework in order to strengthen the position of all tiers of local authority as independent and complementary institutions. This would in particular involve four major steps:

- Improving the quality (clearness and transparency) of laws referring both to the economic activity and competencies of local governments. This should include the simplification of the tax system both for companies and individuals. The formal procedures for establishing a small firm are also far too complex, leading to a bottleneck in the development of entrepreneurship. Legal regulations on local government should include incentives for inter-municipal cooperation in fields that go beyond the capacity of a single entity.
- Decentralization of a given public task should rely on transferring the following three elements to local authorities: political responsibility for a task, legal competencies to manage it, and the financial means to carry it out. Some parts of the decentralization process in Poland have not followed this pattern. Public education is a good example. Municipalities and regions are responsible for school maintenance and the general shape of local school systems. This includes hiring school principals and paying teachers' salaries. However, average teacher

salaries and some general features of teachers' contracts are set by a legal act called the Teacher's Chart, the result of an agreement between the central government and the teachers' union. The local governments had little, if any, influence on the items included in this act. This inconsistency caused major problems in the public education system in the years 2001 and 2002.

- The financial power mentioned above should not be limited to transfers from the central to local budgets (subventions, grants) but should rely to a greater extent on increased possibilities for the municipality, county, and region to create their own revenue. This would help territorial self-governments to develop their own financial policies fitting the properties of particular local economies (making decisions on tax rates, creating tax incentives, etc.). At present, own revenues add about 30 percent (on average) to municipal budgets, and less than 5 percent to those of counties and regions.
- Local governments often find it difficult to assess the quality of advisory services offered to them. The consulting services sector grows very rapidly and consists both of reliable experts and rent-seekers, taking advantage of informational asymmetry, the complexity of laws, etc. The central government (also one of the local government associations or commonly recognized NGOs) might improve this situation by introducing quality certification for consulting companies and individual advisors.

Recommendations for local government are based mostly on the experience of Polish municipalities. The role of regional government in local development is very limited, and three years is not enough to fully evaluate performance. However, some observations suggest that the current learning process is similar to that of municipalities in the early 1990s. Thus, although the following recommendations are meant mostly for the municipal tier of self-government, most postulates are or will inevitably be valid for regions as well.

- Some local governments are unwilling to take responsibility for tasks overtaken from the central administration. They pretend to act as agents of the central government by simply copying policies and attitudes represented by their former "owners." This is referred to as "the intermediary variant" in the subchapter in the full report devoted to education. Such an approach does not create any surplus from decentralization for the local community, and in fact can be used as an argument against the idea of a self-governing society. Cooperation between local governments on the intra- and inter-tier level should be improved to spread out know-how and popularize an active approach to municipal management.
- Close cooperation with local business should be a priority of territorial self-government. However, if possible, authorities should work together with associations of local entrepreneurs rather than particular companies. It is worth



underlining that local governments act not only as partners, but also as clients of businesses. Local government should demand high quality products from local contractees, support competition (e.g. by privatizing municipal companies) and above all—develop and apply transparent rules of cooperation.

- Attracting new investors to a local economy should not replace active policies in support for already existing enterprises. It is often observed that local authorities limit their efforts to creating incentives to newcomers, ignoring existing firms that also need substantial support.
- Local authorities should establish links and cooperate with business assistance organizations and any institution promoting civic activity.
- The effectiveness of economic development policies implemented by local government depend not only on the creativeness of leaders, but on the quality of managers and staff. Skills and attitudes of those “non-political” employees of city hall are crucial for the persistence of long term policies in changing the political environment. Therefore, local governments should invest in human capital and require a higher level of skill from their employees. Training programs should be considered a part of work rather than an opportunity to avoid working. In order to discourage moral hazards, local authorities should develop their own system of assessing employees’ quality, referring to skills rather than diplomas and certificates.
- A policy worth considering is the privatization of selected municipal public services. Successful cases in Poland prove that private companies may very efficiently perform street cleaning duties, areas management, and heating services.
- Cooperation with foreign territorial self-governments (e.g. twin cities) should be intensified and expanded beyond the sphere of culture and education.
- In many cases the use of funds available for promotional activities could be more efficient. Promotion should be preceded by substantial improvement in technical infrastructure in areas of value to potential investors. Frequently, such activity requires a coordinated act by several local governments (usually several municipalities in the same region).
- Although developing strategic plans for economic development is not compulsory for local governments according to Polish law, it is strongly recommended. Strategic planning may help formulate a long term vision of local economic development common to different political groups. Working out a common vision provides a good opportunity to increase citizens’ interest and participation in government. The plan also serves as an important source of information on the locality for local businesses and potential investors. Last but not least, strategic plans of local economic development must be required from municipalities and counties when applying for assistance funds, both from domestic and foreign sources.

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## NOTES

- <sup>1</sup> Both here and in the full report this chapter is devoted only to the competencies and policies applied at the municipal level of self-government. Neither counties nor self-governing regions collect any local taxes, so they do not have any fiscal policy instruments.
- <sup>2</sup> The value of the indicator for 2001 was calculated in a slightly different manner than in the previous years. Aggregate tax revenues of municipalities as compared to potential revenues using maximum rates were taken into account. Therefore, these are more averaged tax rates than an average of the rate.



# The Role of Local Government in Local Economic Development

Russia

*Denis V. Vizgalov*





# The Role of Local Government in Local Economic Development

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### 1. DEVELOPMENT OF LOCAL GOVERNMENTS UNDER THE POST-SOVIET SOCIAL AND ECONOMIC REFORMS

Formation of the local government system has become one of the most characteristic results of market reforms in Russia. Forming the system of local governments<sup>1</sup> is important not only by itself, but also as means of implantation of civil society in Russia. The word “implantation” as a term is not just used at random: transition to the system of local government (together with the majority of other structural economic reforms) is demonstrative of reform “from the top.” This process of developing social institutions mirrors the history of European democracies, where local governments grew out of the “gross democracies” based on the ideology of civil society.

Conversion to the system of local government was one of the primary initiatives of the market-oriented government. But at the same time, introducing local government institutions relegated domestic economic reforms to the background which in turn led to their mismatching the actual economic situation.

For Russia’s municipalities and other local governments, the transition period has resulted in increased responsibilities. The federal government has decentralized a number of functions to the local level, including operation of the social safety net, housing policy, and numerous other aspects of managing the urban economy. At the same time, enterprises which under the Soviet system had been major providers of social services have been divesting their social assets to local governments. One result of the devolution of responsibilities is that municipalities are now the principal administrators for delivering social assistance within the country.

Furthermore, the legislative base of local government was dependent on the municipal budgets of the federation. Formally, those budgets were in the competence of

local governments, however, they were to be fixed based on agreement with regional authorities. This results in one of the biggest problems of municipal economic development—a strong, even decisive, influence of regional authorities upon municipalities during the formulation of the budget. In order to understand the specific character of the local government institutions in post-Soviet Russia it is fundamental to realize that its formation was carried out during a recurring economic crisis provoked by distorted socio-economic structures of municipalities formed by the conditions of command-administrative system as well as by the Soviet planned economy. Regional settlements were being developed in accordance with corresponding directives coming from the top, implementing a “policy of allocation of productive forces.” The scheme was senseless other than within the planned economy system. Its basic postulates were: a) state ownership of all means of production; b) domestic orientation of all production;<sup>2</sup> c) political dictatorship over the economy; d) complete centralization of all resources; e) totalitarian control over distribution of resources.

For municipal bodies under new economic conditions the above policy resulted in a number of significant problems such as:

- narrow economic base (tax base in particular), strong dependence of budgets on a limited number of enterprises
- lack of economic expansion in municipalities, especially “mono-profiled” ones (excluding those where hail growth is based on oil and gas production and processing, showing steady income)
- necessity to support social infrastructure despite the fact that municipal, social, cultural, and housing facilities are relegated to municipalities without provision of sufficient funds.

It was only in 1999–2001, when the general economic situation improved that some cities gained the opportunity to work on their own economic development problems. Starting from 1999, stabilization and production growth in some sectors of the national economy (metallurgy, oil-refining, chemical, and food industries) enabled specific cities where corresponding enterprises were located to stabilize and in some cases even increase tax revenue.

Complete freedom was granted to municipalities to choose the means necessary to exercise their newly obtained powers. The municipalities also had to find solutions very quickly, taking into consideration the growing pressure of the economic crises. As a result, inexperienced local bodies endowed with power started to regulate their activities independently, determining priority items, often experimenting without attempting to evaluate the possible consequences of their decisions. Significantly, the development of local governments varied broadly in different municipalities, resulting in a distortion of both the country’s social economic policy and legislative development. In short, the

organization of local power in Russia was caused by the structural variety of municipalities themselves, their social and economic contrasts, and uneven geographical positions around Russia.

Enormous socio-economic disparities also contributed to the “diversity of colors” of local governmental economic policies, a unique feature of Russian economic development, in which the vast size of the territory plays an important role. Geographic distances between cities is an obstacle to the development of connections between city managers.

The number of municipalities combined with the variety of management structures, resulted in configurations formed in accordance with both the structure and the system of interconnection between the authorities of local governments.<sup>3</sup>

In this context municipalities demonstrate a variety of approaches to the task of local economic development. For example, one group of municipal governments remains economically inactive seeking to retain traditional relations with the federal government. They are not interested in the promotion of new business technologies, legislative and structural reforms, or revisions in their relationship with upper level authorities.

Other local governments attempt to improve their economic standing by using public resources (budgetary funds or municipal property) for commercial purposes. To this end they become shareholders of commercial enterprises, provide credits on easy terms, and cover losses of municipal companies, sometimes even “export” local resources to other localities. The idea to transform a municipality into a sort of corporation with a city mayor acting as a successful manager is rather popular in Russia. As a rule, this exposes public resources to commercial risks; commercial initiatives of public enterprises turn out to be by far less successful than private initiatives; and confusion of customer and contractor functions on frequent occasions results in corruption and abuse.

However, there is a rapidly growing group of Russian cities and towns that are providing another model for municipal-based social and economic development. The goal of such development is the creation of a high-quality urban environment, generally interpreted as positive living conditions for residents, comprehensively defined, and business opportunities for corporate entities within the territory of the city. To attain this goal, efforts should be undertaken to produce proper legal, institutional, fiscal, and other necessary conditions for local businesses, while ensuring the efficient employment of public resources allocated for urban infrastructure and social security purposes.

The formation of effective local governments in Russia are hampered by both organizational problems in the system itself (imperfection of municipalities’ legislative base, low status, small number, structural imperfection of governing institutions, and lack of democratic mechanisms of control). In addition, the following external factors preventing socio-economic development:

- Misunderstanding by both administrators and population of municipalities concerning the origin and essence of modern models of local government, which differ from the “state power/local representative” model.
- Lack of systematization and serious defects in the legislation of the Russian Federation itself (on federal and regional levels). In the field of local governance, contradictions exist between legislative acts at federal, regional, and municipal levels.
- Russian citizens’ mistrust state power and its representatives.
- Lack of distinction between various bodies of power.
- Lack of real state guarantees for granting organization and legislation, information, finance, and other resources for citizens’ constitutional rights as well as for bodies of local government formed by them.
- Lack of educational resources, professors, or even an accepted theory of municipal government.
- Shortage of professionally trained state and municipal officials.

In summary, the following conclusions could be formulated regarding the manner in which power transition from municipalities to local governing bodies has influenced economic development of the regions. These conclusions are not straightforward.

On the one hand, the role of local authorities in local economic development is quite significant. Firstly, there are local governing bodies that, in accordance with Russian legislation, are in charge of conducting local social and economic policy. Secondly, local administrations are, in fact, *the only backbone link within the system of local societies capable of controlling and managing the local development process*. Traditional stakeholders of economic development—entrepreneurs and local populations—remain socially passive and show no interest in managing their territories.

On the other hand, this situation is extremely dangerous since there are no real means of accounting for local government activities from the perspectives of both state authorities and independent citizens. At the same time actual “freedom of action” of local authorities is so great, that many make too liberal an interpretation of their role in local economic development. Thus, economic policies range from dictatorship to anarchy at the municipal level. In some cases, local authorities are aiming at direct regulation of commercial enterprises’ activities, even substituting the latter for themselves, thus creating conflicts of interest. In other cases, they abdicate all responsibility, turning it over to corporate businesses frequently associated with the criminal underworld.

## 2. PRINCIPLES AND EFFECTIVE TECHNOLOGIES OF ECONOMIC DEVELOPMENT IN MUNICIPALITIES: RECONNAISSANCE STAGE

Formally, local government bodies have all the necessary political leverage they need to manage local development, however, political clout can only be effective if these powers are used in a thoughtful, harmonic, and well-balanced manner. As municipal practice shows, this is unattainable for local authorities. Indeed, the diverse economic nature of the tasks listed above requires dramatically different means of resolution, which are not as of yet at the disposal of local authorities.

Functions of local government include, among other things, supplying the population with all necessary social goods (environmental and personal safety, health care, and education), and also consumption goods (housing, catering, consumer services, retail). In addition, local authorities are responsible for the activities of communal services, (traditionally natural monopolies) such as sewerage, water, heat, gas, and communications. The manner in which each of these fields is managed affects the development of the municipal economy as a whole. Administering these spheres is based on different managerial principles; it poses different tactical objectives before the managers, and requires systematization at the municipal level with the help of a comprehensive approach to territorial development planning. In the meantime, most municipal officials originate from their respective positions within the urban economy and, in their managerial practice, rely to a great degree on their narrow experience. This creates additional obstacles to proper harmonization.

The specific character of modern economic development in Russia is such that the application of the aforementioned powers by the local authorities, if used in different areas of municipal management, produces different results. Transition to market relations and increased inter-municipal competition for labor, investment, and production facilities all force active managers to channel local resources in those particular spheres deemed critically important for the socio-economic development of their territories.

Having summarized the economic strategies as they are set out in the key Russian municipalities, as they have been approved during the transition period from the anti-crisis policy to the economic growth policy (1999–2003) we can highlight the most important objectives of local governments:

- creating a favorable investment climate
- encouraging small businesses
- managing land resources efficiently
- creating jobs.

Management of the local economy means working out and rendering separate economic policies. When market relations in the country intensified, the most active

Russian local authorities (mostly in cities) aimed at the creation of favorable urban environments, i.e. they strived to raise the standard of living in cities which, in turn, would indirectly facilitate favorable conditions for economic activity. Quality city environments mean higher living standards. This creates a reliable tax base for the municipal budget—a crucial factor in implementing necessary social services.

For example, places where city managers actively influence the creation of a favorable economic climate combined with attractive and diverse production facilities emerge as centers of economic growth—Yaroslavl, Novgorod, Khabarovsk, Samara, and Cheboksary, Dzerzhinsky, and Zheleznogorsk. On the contrary, inactivity or poor implementation of local economic policy (e.g., unjustified attempts to “conduct” economic processes directly, as in a bureaucratic model of management) are fraught with irrational economic structures, poor business activity, and a decline in the populations standard of living.

Successful economic development programs must have the support and active participation of all community leaders. Because communities differ in their human, political, and natural resources, each community has its own unique set of economic opportunities and challenges; therefore every community must craft its own strategy to maximize its strengths and minimize its weaknesses.

Municipal formations radically differ from one another according to the availability of natural resources, education of its population, and level of economic development. Accordingly, municipal economic policy differs depending on the combination of these factors.

Thus, the general task of exercising self-regulation in maintaining economical policy by local governments forms strategic choices, and on this basis—the social and economic planning of territorial development.

The effective usage of all available resources for municipal economic development, uniting the efforts of all representatives of the local community, may facilitate the achievement of these aims.

Russian cities are actively working to create their strategic development plans. The plans are created within the framework of various national, regional, and municipal programs or as an independent initiative. In this situation it is rather difficult to obtain a comprehensive picture of the state of economic development planning at the municipal level. However, comparative analysis of more than 20 municipal plans and programs reveals several common features, as discussed below.

Towards the end of the 1990s municipal economic planning in Russia was still in its infancy from the viewpoint of logistics and implementation mechanisms. All of the notable programs differ from each other by structure, volume, and content. Notwithstanding the fact that nearly all program designers have a good knowledge of program development and methodology, their interpretation of major concepts and ideas varies greatly, and their use of standard structural program components differs sharply.

Nearly all of these plans and programs are relatively new documents, and their implementation has just begun. Moreover, many of the known programs are based on design documents that did not benefit from public debate or an official approval process. Therefore, at this time it is difficult to estimate their utility and quality.

Nevertheless, at this stage it is possible to identify both the most successive cases of local economic development planning as well as the principal problems faced by the drafters of economic development programs, and in a few cases to offer solutions:

### 3. LOCAL SOCIAL AND ECONOMIC DEVELOPMENT POLICY: PROBLEMS AND SOLUTIONS

For the time being the main problems of local economic development are rather clear. The role of “external” factors in the development of local economies is declining while the influence of “internal” local factors is growing. Firstly, they are directly connected to the problems of development of local self-government institutions. Quality and success of local economic strategies depend, on one hand, on the quality of the municipal management, and on the other hand, on how adequately the financial base of local self-government is provided. Currently, the greatest problem is inadequate balance between the powers that bodies of local self-government obtain in the sphere of economic development management and financial resources provided to render these powers.

In this chapter the principal factors in building effective economic development strategies are listed; they should become the backbone of Russian local economic development activities.

First, the local self-government system must be reformed and local self-government must be provided with a financial base. That is to say there are “external” factors independent of local government activities. But the strengthening of other factors should be determined by local government activities.

#### 3.1 State Reform of Local Self-Government: Trends and Contradictions

Local self-government in Russia faces radical dramatic modifications, meaning basic reconsideration of principles of the local authorities, its territories, and managing organizations. In spite of the existence of local self-organizing institutions, there remains a complex of contradictions, both political and economic in character, that prevents local authorities from successfully managing economic development. It concerns both the

territorial foundations of local self-government, unregulated financial relations between different levels of power, and the fallible budget and tax systems in the country. In June 2001, the Russian president initiated new municipal reforms. The key component of the reform was the preparation of a new federal Law on Local Self-Government, passed in September 2003.

The reform in question aims to differentiate and determine strict economic competence of all power levels, the sources of financing, and responsibility, both for spending funds and carrying out public obligations. In short, the reform is aimed at the regulation of economic relations in the process of the local self-government.

The local self-government reform should not be restricted by the change of local self-government activities. It should provoke changes in the sphere of the federal budget and tax legislation. Amendments to the budget and tax codes, which, firstly, could provide for the balanced and just distribution of financial streams between the budgets of the different levels of power and, secondly, render financial resources of local self-governments adequate to the powers of the local authorities.

### 3.2 Providing Local Self-Governments with a Financial Base

According to expert opinion, a critical factor for the development of municipal economies in Russia is the establishment of a solid financial base for local self-government. The measure of municipal financial self-sufficiency is the municipal budgets' own incomes. At the same time, the revenues of Russian municipalities are insufficiently large to allow financial independence. One of the main reasons is defective federal legislation, which is supposed to regulate budget relations on different levels (federal, regional, and municipal).

Of course local administrations are interested in collecting the main lump of their revenues from their own sources. However, in practice, this share ranges from 10 percent to 50 percent for various municipalities. Hence budget regulation on behalf of the regional authorities frequently reduces to the moderation of municipalities' financial standing *regardless* of the success they enjoy in expanding their revenue base. Cities that lose most because of such an approach are the so-called "donor cities" which make the main contribution to the formation of the consolidated budget of the Russian Federation. For those cities, financial dependence becomes profitable and expanding their revenue base appears detrimental as it leads, inevitably, to the shrinkage of tax benefits the following year. As a result, the size of the consolidated regional budget does not grow and each year it becomes more problematic to fund the municipalities that really rely on donations.



### 3.3 Improving the Business Climate

The business climate refers to the overarching system of laws, regulations, tax policies, and enforcement practices that reflect a municipality's support of private investment. The business climate is a significant consideration in measuring the risk of any private investment. Too much risk can send investors to another community. The fundamental elements in creating a positive business climate in Russia include:

- Real estate ownership protection—protecting the ownership interests of investors in land or buildings and protecting the interests of creditors who may loan money with real estate as collateral.
- Fixed asset protection—protecting the ownership interests of investors in machinery and equipment from arbitrary seizure or theft and protecting the interests of creditors who may loan money with fixed assets as collateral.
- Legal stability and predictability—establishing a court system that provides codified rights to due process for investors in businesses such that they know they will not be treated arbitrarily.
- Transparent government—codifying all rules and regulations and conducting business permitting, licensure and enforcement actions transparently so that investors can be reasonably assured of fair treatment.
- Fair and expeditious permitting and licensing—evaluating applications for permits and licenses according to published standards and procedures and making those standards known to businesses and the public, issuing permits as quickly as possible, providing for an adequate appeal process to help prevent arbitrary treatment and policing the process to prevent graft and corruption.

### 3.4 Implementation of Infrastructure Development Projects

Businesses require quality infrastructure to ensure the flow of materials, products, and personnel, as well as the supply of critical public services such as water, sewer, power, education, and telecommunications. Telecommunications and education infrastructure have become critical ingredients in economic development planning because many types of information-age businesses can relocate anywhere with a well-developed telecommunications systems and highly educated workforce.

Municipalities must also understand that the existence, proper upkeep, and modernization of public amenities—museums, sports stadiums, theaters, parks, and city centers—has a direct bearing on economic development. Decisions by employers, would-be investors, employees, and citizens alike are deeply affected by their attitudes about and pride (or lack thereof) in their community.

### 3.5 Support for and Retention of Small Business and Entrepreneurs

In societies that embrace individual freedom of choice and movement, human beings and the institutions they work for are involved in a constant search for communities that offer them the most positive and supportive environment in which to enhance individual economic well being. It is therefore no surprise that small and medium-sized enterprises (SMEs) are the backbone of a free enterprise democracy. They become the most common manifestation of the search for better ways to enhance individual economic well-being while building communities.<sup>4</sup>

### 3.6 Attracting Business and Investors

Historically, this activity was considered the primary function of local economic development experts. Because substantial research has shown that a majority of new jobs are created by businesses already located in a community, emphasis has shifted somewhat to business retention. Most communities, however, maintain some level of active effort to attract and recruit new businesses. The following are the major components of a business attraction and recruitment program:

- Marketing: communities undertake a variety of marketing programs depending on the local budget and need for new businesses including the following:
  - working with professional site location firms
  - direct mailing to lists of businesses that might be interested in their area because of labor supply, raw materials, related companies as suppliers or customers
  - advertising in general business publications
  - advertising in industry-specific trade publications
  - participation in industry-specific trade shows
  - promotion of direct foreign investment through trade missions and trade shows.
- Prospect management: it is important to treat business prospects well, because the local economic development office is usually the first impression the prospect has of the community. Good prospect management includes:
  - developing a professional reception program for business prospects that includes a standard list of services
  - being responsive to the needs of the prospect

- providing a variety of services to the prospect including the ability to refer the prospect to knowledgeable resource professionals
  - following up and responding to all requests.
- Deal packaging: working with the prospect to help assemble the package of information, financing, incentives, regulatory approvals, training programs, and other aspects of the development package that are required to get all parties to commit to the deal. This is a senior staff function that is usually assigned to the most experienced economic development professionals in the organization.

### 3.7 Human Resources Development

Currently jobs in municipal bodies are not prestigious and offer low remuneration. One of their few advantages is relatively stable and secure employment. The desire to seek a position (with a small but regular compensation) in this particular sector frequently arises solely due to the inability to find other employment. This may relate to the fact that most certified specialists in local government bodies are female and close to retirement. Women occupy about 75 percent of municipal jobs; they, as a rule, are the most well-educated segment of the local self-government potential. This is especially evident in small and medium-sized cities, and in rural townships where the borderline between local “authorities” and the population is particularly transparent.

Approximately 30 percent of municipal administrators have obtained a degree in humanities. At the same time, among municipal officials, there’s an intense deficit of professionals with a specialized background in economics (10 percent). Finally, only one percent of specialists are professionally qualified in the field of state and municipal management.

The distribution of human resources in municipal management is uneven among Russian municipalities. For highly qualified managers, work in a large district center is preferable to work in the administration of a regional center. Most managers participating in local elections is not a goal in itself, but rather a springboard which can help them satisfy their career ambitions in various state structures on a higher level. Thus we witness the depletion of managerial resources in small cities.

The complexity of municipal management on one side, and the dearth of human resources, financial, and informational resources on the other, prevent municipalities from managing local resources in a consequential and balanced manner in addition to hindering them from solving strategic and operational ones.<sup>5</sup>

One of the primary ways in which the quality of municipal management can be improved is through the creation of a municipal staff training system. Complexities in

education for municipal management abound; they include, among other things, the diversity of local government functions and the variety of organizational and territorial forms of local self-government, each of which requires a knowledge of a specific professional skill set.

### 3.8 Developing Partnerships at the Municipal Level

#### *Attracting citizens to municipal management*

The feeble civil society institutions on which municipal self-government is supposed to base its decision-making process are one of the main impediments to local development. Decisions made by authorities that do not account for public opinion frequently fail to reflect their interests, often meet resistance from respective populations, and therefore cannot be properly implemented.

Local self-governments have unique opportunities to forge vital social partnerships because on one hand they command powerful administrative, informational, and material resources within their territory; and on the other, they are not bound by social commitments like the federal power.

Public social activity in most Russian cities is currently very low; moreover, there exists a widely entrenched stereotype that the social submissiveness of the citizens is inevitable given the complications the country faces in development, the national and regional mentality, etc. This is not entirely true, because the position of the citizens is to a great extent formed by the model of city management, by the position and viewpoint of the local authorities.

When strategic decisions are made, it is very important to include citizens in the decision-making process by providing appropriate feedback and information networks. Adequate provision of information acts as a stimulus for citizens to manifest their social initiative. Therefore the first step towards public participation is informing the citizens on an active and regular basis and attracting them in advance to the process of city planning and development.

#### *Public-private partnership*

Market economy and local self-government create favorable economic premises in which labor can be divided between the public and private sectors in the allocation of goods and services within city limits. This partnership serves to join the resources of the private sector (such as market orientation, entrepreneurial spirit, access to finance, business experience, and familiarity with technology) with the resources controlled by authorities (public responsibility, legal regulations, social obligations).

These public-private partnership mechanisms are not widely spread in Russian municipalities. One of the most actively expanding forms of this partnership at this stage is the placement of municipal order, however, attracting business to the supply of social goods is often organized in an inefficient preferential manner, sometimes in violation of local law.

At the same time, there exist a number of legal and organizational ways to implement the public private partnership that can be successfully (and to the satisfaction of both parties) used in the development of urban economies (concessions, long-term leasing of municipal objects, temporary privatization).

### 3.9 Developing Inter-municipal Cooperation

The establishment of multifaceted cooperation between local powers is extremely important for the development of local economic systems. During the era of the Soviet planned economy, what mattered most for the local authorities was the creation of a *vertical* network of connections in the hierarchy of power as opposed to a power structure based on *horizontal* (inter-regional and municipal) connections. This fact has left its imprint on the way regional infrastructures have developed and also on the nature of economic and personal relationships between local powers.

Inter-municipal cooperation is essential within a market economy. The specter of these relations is extremely wide: it encompasses simple information exchange on one end and the joint organization of economic programs on the other in addition to the fruitful lobbying of mutual interests on the federal level. The necessity of active cooperation between bodies of local government has not been realized by all of them.

Different inter-municipal associations face different goals and tasks such as:

- 1) establishing information exchange between municipalities
- 2) providing consultation services and methodological help to self-governing bodies in order to increase their problem-solving potential
- 3) supplying associations with reference services concerning the questions of municipal socio-economic development
- 4) joint development of analytical products (i.e. educational or legislative) and services, which local administrative bodies can then use to their benefit
- 5) disseminating (among the municipalities interested) information concerning the best practices of reforms at the local level, about foreign and domestic experience of economic development, about the successful cooperation between local authorities and state bodies, business, scientific circles, not for profit enterprises and public associations.

## 4. CONCLUSIONS

The making of a market economy requires that effective economic policy be worked out and implemented locally. Municipalities that have now become separate agents of economic life are increasingly becoming real players in the economic game and concentrate increasingly on their own development. Although local self-government reform initiatives are incomplete, local authorities already enjoy important strategic development decision-making powers that are secured in the Constitution.

Economic development—just like business itself—is *competitive*. Every municipality wants the jobs, increased incomes, investment, and tax benefits that come from successful businesses. For economic development to be successful, the focus must move from needs to opportunities, from a concentration on what is wrong to a concentration on future possibilities.

Local governments in contemporary Russia have both substantial resources to implement economic development policy and serious limitations and constraints that may exacerbate it.

*Main resources:*

- democratic and market-oriented legislation both on federal and regional levels
- the operation of self-governing institutions on a local level
- municipal governments are in charge of important local recourses (real estate, land resources, municipal finances, the powers of establishment the regulatory environment, etc.)
- the electoral principles forming local authorities
- development of public-private partnership technologies among municipalities.

*Main constraints:*

- shortage of highly-qualified municipal officials
- constant need for financial resources through inter-budgetary relations
- substantial social burden of local budgets as the heritage of the Soviet economy
- long and difficult reconstruction of local economies in the post-crisis period
- relatively low quality of the regional investment climate.

As most problems of the local economy are rooted at the local level, their solutions can be found at the municipal level by resorting to the skills of local managers. The purpose of local socio-economic development is the creation of an appropriate environment, understood herein as a comprehensive system including decent living standards for the population and economic subjects that function flawlessly on the territory of each given municipality.

A range of measures are being implemented to that effect targeted at the creation of legislative, organizational, tax and other constituents of the environment where the

entrepreneurial sector operates. They are also intended to create efficient spending of public resources in the city economy and also of the funds allocated to social needs. Municipalities start competing for investment, redistribution of cash flows, workforce, etc. Local bodies are progressively more endowed with the power to act independently, though their responsibility for their decisions grows in tandem.

The mutual relations between local authorities and businesses that are currently emerging regionally in Russia is a very important issue. Businesses want to know that they will be considered citizens of the community and that they will receive their fair share of local public services. Businesses are concerned about regulatory restrictions and permit processes; they expect fair treatment and want local officials to respond when problems arise. They are also concerned about the likelihood of neighborhood protest against nearby development; their hope is that the community's citizens will accept and patronize their respective businesses.

Widespread public participation is an important condition for the successful development of municipalities. When forming strategies for local development it is necessary to take into account the opinions of all representatives of local communities, to ensure their participation in the realization of municipal programs and constant public supervision over decisions. One of the necessary conditions of such participation is the transparency of local government actions.

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## NOTES

- <sup>1</sup> There are 12,261 municipalities in the Russian Federation at present. Their types are administrative *rayons* (12%), cities including those of republican, regional, and *oblast* subordination (4%), city *rayons* and districts (urban settlements) (25%), and rural settlements (58%). The average number of municipal officials per municipality is 46. Along with that their number differs considerably among the different municipality types. Thus, about 180 officials have positions in city administrations on average and only 19 in rural administrations.
- <sup>2</sup> Excluding energy resources and armaments.
- <sup>3</sup> Most popular (in 67 regions) is the organizational form when the elected head of municipality dominates, leads local administration, and simultaneously acts as a chairman of the representative body of the local government.
- <sup>4</sup> At an address to the State Council in December 2001, President Vladimir Putin proclaimed that Russian SME employment should be drastically raised from its current 12 million people to 40 million. Pointing to the current 10–11% SME share of Russian GDP—compared to 50% of GDP in the USA and 63–67% of GDP in Poland—Putin urged adoption of a Russian SME goal of 30–40% of GDP. Such dramatic increases in SME economic activity can only be achieved if there are equally revolutionary changes in the business environment in Russian communities. Furthermore, the communities that create an environment in which individual initiative and enterprise formation thrive—and in which creative individuals, entrepreneurs and organizations feel secure and supported—are the communities that will achieve the financial and political success to which all communities aspire.
- <sup>5</sup> In particular, most municipalities are still coping with the problem of creating an efficient structure of city administration. While the law stipulates that structuring local administration belongs to the range of locally solved questions, which each municipality is free to handle as it likes, in practice the structure of city administra-



tion is formed according to the industrial branch principle (especially in smaller towns). At the core of this model, which was formed back in Soviet times, is the idea of budget planning whereby budget payments have to pass the accounts of industrial branch departments of the administration. This industrial branch management structure is in fact inefficient and costly, and where it is in place, sectional managers have no interest in cutting their expenditures and improving managerial practices.



# The Role of Local Government in Local Economic Development

Slovakia

*Ján Buček*



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### INTRODUCTION

Urban and rural communities in Slovakia could not avoid contradictory negative consequences of economic transformation. They were accompanied by decreasing local economic performance due to loss of markets, closures of non-competitive companies, or rising productivity, altogether expressed in increase of unemployment. With approximately half a million unemployed citizens (17.7 percent unemployment in January 2003) half of which are among the long-term unemployed, economic development has been a highly prominent social problem. Despite the fact that the past two years (2002–2003) can be considered a period of stabilization or minor improvement in the field of the labor market,<sup>1</sup> deep regional and local disparities have not been reduced. Large differences are also apparent in the fields of entrepreneurial activity or foreign investment distribution. Questions such as the negative impacts of economic transformation and restructuring, modernization of the production sector, support of new businesses, and generation of new jobs have become very acute. Despite this pressure, policies addressing local economic development (LED) have been long neglected. The federal state as well as local self-governments started to pay more attention to initiatives in this field during the second half of the 1990s. The primary aim of this study is to reveal the role of local self-governments in local economic development in Slovakia—their fields of action, applied tools—as well as to identify the limits of such activities and potential improvements. This study follows a more pragmatic approach to local economic development stressing the crucial role of generating new jobs and businesses, or at least the protection of existing jobs and businesses, as well as successful economic transformations at the local level. The study is based on the collection, analyses, and evaluation of relevant information on local self-government involvement in local economic development

in Slovakia. Research methodology included the study of related legislation, official documents of central state institutions (programs, budgets, regulations) and local self-governments (local by-laws, local council decisions, planning documents, agreements and contracts, budgets) research in national, regional/local, or specialized print media and electronic information resources, and questionnaires in selected cities. In total, information concerning 36 cities was used in a systematic way to understand the role of economic development in Slovakia.

## 1. ADMINISTRATIVE AND LEGAL FRAMEWORK INFLUENCING LOCAL SELF-GOVERNMENT'S ROLE IN LOCAL ECONOMIC DEVELOPMENT

### 1.1 Administrative and Legal Position of Local Self-Government

Slovak public administration is of a dual nature, with relatively separate domains between self-government (local and regional) and state administration (district and regional general administration, specialized administration). Current development is typical insofar as it involves the strengthening of self-government while reducing the role of state administration. More powers have been transferred to local and regional self-government within public administration reform since 2002. District offices of state administration should be cancelled from 2004, however a network of specialized state administration field offices will be working at the district level (although in some cases not in all current districts). Local self-government and regional self-government also are two independent levels of self-government with their own independent legitimacy. As a result local self-government can act independently in local economic development, respecting legislation without any direct intervention from other public administration bodies. Local self-governments can cooperate with private and third sector bodies, use their own resources and property for entrepreneurial purposes, combine resources with other self-governments as well as other legal entities.

The principal legislation concerning local self-government is the Communities Act. It also defines the basic framework for local economic development activities. Main powers and functions of local self-government most relevant to local economic development include the administration of municipal property; adoption of local budget and final account; local fees and taxes administration; supervising of economic activities (including adoption of binding decisions on investment activities and starting of entrepreneurial activities); construction and maintenance of local roads and other municipal facilities; organization of public services provision; own investment and entrepreneurial activities; adoption of territorial planning documents, as well as development documents

concerning particular spheres of local life; establishment and control of own budgetary and contributory organization and other legal entities. In 2002 municipal authorities started to transfer important powers related to local economic development to local self-government,<sup>2</sup> such as powers in territorial planning and building order, regional development, and tourism (including programming, the implementation of development strategies and plans, and coordination of legal entities cooperation in programming activities). As a result, the role of local self-government in the field of LED is expanding.

A whole set of legislation determines the financial aspects of local self-government. A freedom in decision-making over fiscal issues (incomes and expenditures) is counterbalanced by lack of resources and appropriate property for LED. The main problems are in limited opportunities to generate regular and sufficient incomes, and a large dependence on transfers from the state budget and obligatory expenditures. It leaves a very narrow range of resources available for LED initiatives. Restrictive financial rules are included in the Budgetary Rules Act. According to this act, local self-government can provide subsidies and returnable financial support from local budgets to legal entities established by the community for concrete tasks, in the public interest and in favor of the development of the city's territory. Local self-government may provide similar financial support to other companies located in the municipality, but it can be supported only from its own revenue and for support of public services, entrepreneurship, and employment. Such support cannot lead to an increase of local self-government debt. Local self-government also cannot guarantee credit obtained by outside legal entities. More limits will be applicable in the field of local self-government borrowing from 2005.<sup>3</sup> The impact of state aid legislation on local self-government support of LED is diminished by the minor financial capacities of local self-government. Local self-governments, local public companies, as well as association of legal entities including local self-governments are obliged to act within Public Procurement Act. Any services, goods, and works must be acquired within the framework of this legislation, for example, it eliminates direct contracting from local companies by local self-government in order to support the local economy without any tendering.

Important portions of local incomes generate shared taxes and state subventions. Their level fully depends on central level decisions within state budgeting processes. A similar situation exists in most other central state subventions and distribution rules. While a share of personal income tax is distributed according to population, the share of legal entities' income tax is distributed 60 percent according to population and 40 percent according to the location of the taxpayer. Thus, there is a clear incentive for local self-governments to support business development in their community. In fact, transfers from state budgets stagnate in relation to the inflation rate and tasks executed by local self-governments.

The initiatives of local self-governments in administering local taxes and fees restrict a certain level of uniformity fixed in legislation (the Local Fees Act and the Real

Estate Tax Act). Taxable activities/items are explicitly listed, as well as upper limits of related taxes and fees. Although local self-governments have a certain level of freedom in modifying local taxes/fees, such conditions reduce their chances in adopting more diverse and individual incentives in support of local economic development. Local self-governments are free in setting rates (and tax reliefs) of a large variety of local fees within limits mentioned above. Legislation in the field of property tax (real estate tax) is similar. Basic tax rate categories are listed; general conditions of tax reduction are stated precisely; and no special pro-development measures are included in the legislation. Local self-governments adopt by-laws for administration of local taxes/fees local that specify tax rates and all conditions of their collection.

Local self-governments (mostly large cities) are large real estate owners. All property resources can be sufficiently freely exploited in support of local economic development. It must be in agreement to principles of municipal property utilization rules adopted by the local council, and main transactions must be approved by the city council. Municipal property can be used as capital in municipal enterprises or for other entrepreneurial activities. Limits in exploiting municipal property are related especially to property transferred to local self-governments within processes of decentralization (e.g. schools, hospitals). On the other hand, the property of many communities is negligible, in poor, or unsuitable, thus reducing its use as an LED initiative.

Local self-governments have extensive rights in founding other institutions, as well as participating in other legal entities that are very important for the organizational framework of their local economic development initiatives. From possible forms, prevailing institutions with communal participation are budgetary and contributory organizations, limited liability (s.r.o.) and joint stock companies (a.s.), as well as associations. Local self-governments as a founder guarantee and supervise the activities of budgetary and contributory organizations. They must follow the financial relations defined within local budgets. Their activity is managed according to their own budgets. A contributory organization can also execute entrepreneurial activity, but with permission from its founder (i.e. local self-government). Local self-government can participate in business according to the decision of local councils (including those under the control of private partners). An association of legal entities is often the legal form of non-profit organizations combining partners from various sectors (state, public, private, non-profit) in one subject.

Trends in the development of transparency and democracy in local economic development have been promising since 2000. The Communities Act defines the requirement to make the local budget, local final account, and local council meeting program available to citizens. Important issues can be discussed with citizens at public assemblies. The act does not detail what information should be available, when, and for how long, thus leading to large discrepancies in accessible information among local self-governments. Despite a basic obligation for transparency and information accessibility within local



self-government legislation, there emerged disputes over local economic development in some cities. This was often caused by the absence of a well-elaborated and clear information/communication policy, as well as an absence of clear rules and procedures concerning decision-making. An important shift has been signaled in the adoption of the Free Access to Information Act. Local self-governments introduced special information offices, contact persons, as well as their own web pages for information provision. Specific information is provided on request.<sup>4</sup> Important obligatory information and participatory rules also are set up by legislation within the framework of territorial planning documents adoption, however, conditions of transparency and citizen participation are not explicitly well-defined in a case of local development planning and programming, maybe reflecting its early stage of development and weaker legal position. Visible progress is observable in defining transparent rules and procedures within the central level policies addressing local economic development (programs and grant schemes).

## 1.2 Regulatory Powers of Local Self-Governments

The main regulatory powers of local self-governments in Slovakia include decision-making over economic activities in the city, local by-laws, and local planning documentation. Currently, cities rarely formulate detailed and clear conditions for economic activities functioning in localities. Elaborate economic development oriented initiatives formulated in local bylaws are exceptional. More attention is paid to standard planning documentation and its actualization (binding part of territorial plans is also adopted as a bylaw). Considering territorial planning documents as sufficient in the field of LED, it reflects a “reductionist” perception of the role local self-governments occupy in the field of local economic development planning. Standard local economic development planning and programming began to expand in Slovakia only within the past few years.

Local self-government can efficiently regulate economic activity on their territory, and according to legislation, adopt agreements, binding statements, or proclamations to entrepreneurial and other legal and physical entities, as well as determine the location of production units on its territory. Local powers have enjoyed greater autonomy concerning public construction: these strengthened powers include the issuing of building permits. Local self-governments use their powers to determine specific business conditions in addition to facilitating related procedures. In practice Slovak municipalities confirm the limited implementation of local by-laws (regulations adopted by local self-governments) for setting clear conditions for initiatives concerning local economic development (e.g. as explicit by-laws). Local economic development under such conditions remains unsystematic, without a stable framework from local self-governments, leaving LED to function on a case by case approach. At the same time, measures to support local economic development are also rare in local by-laws (those addressing

other local affairs). They are marginally addressed in by-laws concerning subvention programs from local budgets and rules for municipal property use (e.g. the selling and renting of property).

Territorial planning has dominated local level planning. Additionally, within the past decade environmental planning has become a major priority. Until now, these two aspects of planning have had the strongest impact on local economic development (Building Act 50/1976 as amended). Any activity has to comply with regulations set forth in territorial planning documentation. These documents concentrate on defining the framework and limits of local development, urban physical structures, and land use. Unfortunately, they neglect more elaborate economic development issues, financial measures, implementation strategies, and responsible management structures. Under current situation, local self-governments facing concrete interests of entrepreneurs/investors are immediately changing existing territorial planning documentation or turning to their large-scale realization in advance.

Standard development planners (including external aspects within territorial plans) introduced the Support of Regional Development Act (503/2001). This act defines a new hierarchy of programming documents. The Municipal Economic and Social Development Program is a mid-term document containing specific analyses of social and economic development, outlining needs in the fields of technical infrastructure, social infrastructure, human resources, education, etc. It must also include a proposal that details financial and administrative measures. It should be the main LED document prepared by local self-governments. Adoption of this act in 2001 resulted in a series of pilot programs that are currently under elaboration. Nevertheless, earlier initiatives of individual cities in this field were often prepared in cooperation with foreign consultants.

### 1.3 The Central Administration as a Partner with Local Self-Government in Local Economic Development

Central state initiatives address the establishment of a basic legal framework, the formation of specialized institutions and programs, and the distribution of various supports. Nevertheless, state institutional involvement in LED initiatives was reduced over the long term. In addition, it did not offer enough space for local initiatives, including local self-government participation. Programs initiated by the central state were minor, with a limited amount of resources, under the control of central ministries, with reduced access to local actors and questionable transparency. The expansion of central state activities related to the 1998 shift in the ruling party and to EU pre-accession processes has been positive, but are still financially insufficient. The implementation of many central state initiatives are strongly dependent on local self-governments. In most cases, local

self-governments cannot handle the administrative and financial demands.. As a result, large scale implementation progresses slowly and cannot improve the development opportunities of many communities.

State support for industrial park developments and investment incentives are among the leading initiatives accompanied by large expectations. Unfortunately, they are in the early stages of their expansion and so broader consequences have yet to manifest themselves. Formal requirements for obtaining related state support is very strict, complicated and time consuming for applicants. Success of industrial park developments (Act No. 193/2001) is strongly dependent on local self-government activities, because industrial parks (territory with a concentration of industrial production or services delivery) establish and support local self-governments. Subventions can be obtained for technical infrastructure development, refunding of land dispossession, and purchase (rental or exchange) of needed land. State support cannot exceed 70 percent of total costs that limit activities of particular communities. Another barrier in expansion of industrial park development is the limited administrative capacity of local self-governments. Extensive preparatory works as well as documentation is needed to receive financial support (territorial plan, prepared land, and agreement with two potential investors, etc). In fact, only a few projects are successfully progressing, although future potential is quite large. The act on investment incentives (Act No. 565/2001) defines conditions for the provision of investment incentives as individual state aid in favor of regions, without any active role for local self-governments. Main forms of incentives include tax-relief, subsidies for newly created workplaces, and workforce retraining subsidies for large investors. These incentives do not seem attractive enough, procedurally complicated, and thus adjustment is necessary (only one pilot project was approved in June 2003).

Small and medium-sized enterprise (SME) development is one of the long-term goals dating from the beginning of the transition period. Key coordinating institutions in this field concerning all levels (national, regional, and local) include the Ministry of Economy and National Agency for Development of Small and Medium-sized Enterprises (NADSME) affiliated with the Ministry of the Economy. Core activities are in developing credit and guarantee schemes stimulating SME development and support of managerial, marketing, financial, and technical skills of entrepreneurs by means of advisory and information centers (Regional Advisory and Information Centers—RAIC's, Business and Innovation Centers—BIC's, and First Contact Points).<sup>5</sup> The main aim of the support network centers is in assisting SME's to develop or expand in their respective regions and localities. This network supplements the slowly growing number of business incubators. The number of existing programs and institutional frameworks supporting SME's is large. On the other hand, it is too fragmented and diverse, the capacities of individual programs and institutions too small, conditions often strict and diverse, and finally, the ability of major support disputable. Support and accessibility for the smallest entrepreneurs and those in peripheral local centers is also highly suspect.

An important partner for local self-government initiatives in the fields of infrastructure development, rural development, and territorial planning is the Ministry of Environment. Its main approach represents subventions addressing the improvement of local development potential or assisting in overcoming certain development limits. Subventions serve to support investments in water distribution, sewage, water cleaning stations, etc. Their non-existence or insufficient capacities prevent acceleration of development in some localities. They also address territorial planning, revitalization of the territory, and village restoration programs. The ministry is also responsible for setting territorial planning legislation and nation-wide planning objectives. Development initiatives in rural areas are administered by the Ministry of Agriculture. It focuses on supporting new entrepreneurs in agriculture, forestry and fishing, labor productivity, and market structures. Support of new production and service activities generating new jobs outside the aforementioned sectors in rural environments is also a vital aspect to the program.

Despite well-known socio-economic differentiation there were two programs available to LED in economically underdeveloped regions and localities. Two initiatives that have had a large impact from the perspective of local economic development—programs providing financial support in districts with high unemployment (focusing on entrepreneurs with up to 50 employees) and the establishment of Regional Development Agencies (RDAs). RDAs have an impact on the growth of many local economies as well as in linking together many local and regional development initiatives. They usually cooperate closely with concrete local self-governments in the implementation of particular development projects. Local self-governments are also partners in establishing RDAs. These should serve as training centers in local and regional economic development, methodical centers for local and regional self-governments, and as advisory centers in the field of pre-accession and EU structural funds. RDAs are financed from two main sources—their own resources and from state budgets. It is possible that links to state budgets will be decreasing, to be replaced by similar links to regional and local self-governments.

According to the Ministry of Construction and Regional Development, the integrated network of Regional Development Agencies in September 2003 included the following: Banská Bystrica, Čadca, Dolný Kubín, Galanta, Humenné, Komárno, Kežmarok, Kráľovský Chlmec, Lučenec, Malacky, Moldava nad Bodvou, Nitra, Prešov, Prievidza, Rimavská Sobota, Rožňava, Senec, Spišská Nová Ves, Svidník, Šahy, Trenčín, Trnava, Želovce, and Žilina.

Although the main responsibilities for employment are under control of the National Labor Office, the role of local self-governments has been growing over the past few years concerning their extensive participation in public works with a direct effect on local unemployment levels. Employers receive contributions to employee wages and insurance payments as well as coverage of some other costs.

Finally, the Employment Act also strengthened the status of local self-governments in relation to local employment as well links between them and district labor offices. Local self-governments are now considered institutions with powers in the field of employment policy. Active employment policy is to a large extent dependant on local self-government involvement. They also influence setting the priorities of labor market policy, its strategy and target groups, district labor office budgets, etc., by means of participation in supervisory boards of district labor offices. Nevertheless, local self-governments should attain a more active role in shaping employment policy according to the needs of their local economies.

## 2. LOCAL SELF-GOVERNMENT ACTIVITIES IN PROMOTING LOCAL ECONOMIC DEVELOPMENT

There is a wide range of development available for local self-governments. Unfortunately, many of them only apply a narrow scope of tools or remain passive in this field. The most frequently used resources are land-based tools, including participation in technical infrastructure development. Almost every city is active in local marketing and promotion initiatives. Local self-government financial scarcity resulted in a less extensive use of financial measures.

### 2.1 Business (SME's) Development

Supporting the creation of new businesses' are primary goals. Sustaining and expanding already existing local companies also a greater priority than before. Support of technological upgrading and innovations in local economy are rare. Although local self-governments have played an important role in the transformation of some local economies, they are less efficient in the shaping of local business environment. A compact approach to the local economy and well-elaborated schemes in support tools application are in most cases missing.

Local self-governments play an important role in establishing small and medium-sized enterprise support institutions. These activities are often initiated by external actors (e.g. state or local associations of entrepreneurs) but with the inclusion of local self-governments. Such institutions (see Table 2) have crucial roles in delivering information and assistance on start-up businesses as well as local access to detailed information on programs and resources available to support SME's. Unfortunately, the majority of these institutions are concentrated within large urban centers. Until now, they haven't sufficiently addressed localities facing social and economic decline. Local initiatives addressing SME development is expected to be spearheaded in the establishment of

First Contact Points in selected smaller and peripheral centers.

The most widely used tools in SME development are:

- transparent local regulatory framework
- advisor and consulting services provided within local self-government
- *regional advisory and information centers* (present in Bratislava, Dunajská Streda, Komárno, Košice, Lučenec, Martin, Nitra, Poprad, Považská Bystrica, Trenčín, Zvolen, Trebišov, and Prešov)
- *business innovation centers/business incubators* (present in Bratislava, Prievidza, Banská Bystrica, Spišská Nová Ves, and Košice)
- *first contact points* (present in Bardejov, Brezno, Levoča, Medzilaborce, Michalovce, Poltár, Sabinov, Snina, and Veľký Krtíš).

## 2.2 Employment and Labor Force

Most activities address the unemployed and local education/training sectors; they should increase employment opportunities and improve labor characteristics of the local population. One of the most successful activities of local self-governments is to generate the creation of new jobs for the unemployed within an active employment policy framework.

Local self-governments are not directly responsible for general, secondary, vocational and university education, nor for the training or retraining of the employed and unemployed—the most important factor for local economic development. The influence of local self-government as well as the local business sector in education is expanding through local school boards,<sup>6</sup> where representatives of local self-government as well as other local subjects are represented. More efficient links among vocational training schools, local businesses, and local self-governments are rare. Vocational schools often prepare students without employer cooperation and feedback. Education and training activities also cover many institutions under control or with the partial involvement of local self-governments such as Business Innovation Centers and Regional Development Agencies. Local self-governments in many cities have been active in initiatives to attract and expand university education. They developed a large effort to find suitable operating functions (building construction, student accommodation, and housing for teachers). The formation of new universities that reflect the economic profile of particular regions is a very positive sign.

The most frequent tools local self-governments apply in support of employment and labor force include:

- employment generated by means of participation in active employment policy programs

- employment within public companies established by local self-governments
- participation in shaping local education sector
  - secondary education/vocational training
  - university education
  - retraining the unemployed
- protecting easy access to centers of employment by support of public mass transport
  - subsidies to local mass transport companies
  - subsidies to regional mass transport companies
  - regulation in mass transport operation, including fare.

## 2.3 Marketing and Promotion

Marketing and promotion activities organized by local self-governments are becoming a frequent tool for strengthening the local economy. They are mostly oriented toward “selling the municipality” to the external environment. Most of their activities revolve around attracting tourists and to a lesser extent potential investors. However, in many cases, they often lack a sufficient marketing base, have the character of a more general promotion, and are insufficiently focused on potential “customers”—visitors or investors. Distribution of information on local amenities and tourism infrastructure predominates. Promotion activities offering local economic development potential are less frequent and less elaborate. Many of these activities are inter-communal and/or public-private partnership based, to a minor extent executed by specialized external subjects.

Local image promotion is mostly oriented towards attracting tourists, new investors and the strengthening of related services in this segment of the local economy. Most standard approaches use printed materials (books, brochures, guidebooks, leaflets) and their distribution in addition to the use of electronic promotion (web pages and compact discs). Cities frequently present themselves in tourist fairs not only in Slovakia, but also in the countries from which tourists are most likely to come from (Czech Republic, Poland, Hungary, and Germany). This type of promotion is frequently accomplished through the presentation of local investment opportunities in specialized real estate fairs, development conferences or investment forums. Information packages prepared by some cities include basic information on the local economic environment, details on available land and buildings for investors, location characteristics (transport connections, infrastructure) and planning regulation information. Besides the active dissemination of information, local self-governments also search for specialized partners in the dissemination of information on their development potential through state and private agencies’ databases.



In summary, the most frequent tools in this field are:

- local image promotion
- participation on specialized fairs, conferences, investment forums
- elaboration of local economic development information package
- dissemination of local economic development framework information
  - by own means
  - their inclusion in specialized external databases.

## 2.4 Locality, Land, Buildings, and Infrastructure

Local self-governments have recognized their important role in preparing suitable localities for economic development, focusing on land and infrastructure issues. It is the principal and the most extensively applied tool of local self-governments in LED acceleration in Slovakia. Besides these individually applied tools, the most visible effort has focused on forming more complex industrial parks.

Land-banking as acquiring and improving contiguous parcels of land (Blakely and Bradshaw 2002) is an expanding strategy of local self-governments. More active cities have turned to the policy of acquiring new land, and/or the consolidation of dispersed land by purchasing it from private owners. Some local self-governments have participated in the revitalization of old production premises (mostly closed, bankrupted company sites). In some cases, such locations needed clearance work and basic adjustments performed at the expense of local self-government. In addition to the expansion of land use on extensively used premises. They were converted into more intensive and flexible land use patterns, suitable for more companies, at more reasonable costs, often having all types of technical infrastructure available. Self-Government initiatives in upgrading of suitable location by investment into technical infrastructure are also frequent. Depending on their financial situation and position according to investor's, they invest in roads, electricity network, water and sewage, etc. According to Čapková (2001) the selling or renting of land/facilities, at favorable conditions, is the most frequently used tool for the support of the local economy by local self-governments. Exchange of land parcels often enable existing companies to expand into neighboring areas, or to acquire land needed for infrastructure development related to these activities. For a large number of local self-governments, it is most efficient to support the expansion of pre-existing investor activities and private development initiatives.

Numerous local self-governments have mobilized their capacities in preparation of industrial parks, motivated by the central state support scheme. Their activity is inevitable in the basic planning framework and concrete project elaboration. They must have the resources to cover their own share in industrial park-related investments. Very often



they play an important role in the acquisition of required land from previous owners, including its purchase from local budget resources. They also have to attract potential investors needed in order to apply for central state support. The number of industrial parks that were already approved (in March 2003) for support is not high (seven) despite the large number of proposals. Although not all industrial parks are planned as green field investments, a large number of brown field locations already existing in Slovakia could be more suitably exploited. Local self-governments could participate in the conversion of abandoned and outdated production sites into sites attractive for potential investors.

The most frequent tools used by local self-governments are:

- land banking and support of economic development locations formation
- local self-government property register and urban geographical information system providing easy access to land-based information
- finding suitable economic development locations and their delimiting in local planning documents
- purchasing land for future development from private owners
- concentration of dispersed land ownership
- acquiring land or buildings from former state enterprises and institutions
- completely acquiring “old economy” premises (brown field locations)
- clearing devastated and functionally obsolete locations with potential for future development
- participation in land use intensification
- purchase of land at favorable prices instead of land repossession in the public interest
- investment in technical infrastructure (transport, energy, etc.)
- capital participation by land and buildings
- locality, land, and infrastructure-based support of privately based economic development localities formation
- selling and renting land/other real estate (buildings, administrative and production spaces)
- selling/renting land/other real estate at favorable conditions
- price reductions
- selling land in installments
- exchange of land between the city and other subjects for economic development purposes
- involvement of local self-government in infrastructure development
- local self-government upgrade and extension of infrastructure capacity
- formation of complex and larger scale local economic development areas
- industrial science and technological parks.

## 2.5 Financial Tools and Financing

Financial tools applied in support of local economic development, and the local self-government's direct involvement in financing local economic development are important. As already confirmed by Čapková (2001), the most common tools in this field concern local taxes and fees—exemptions, abatements, payment postponement, etc. Most local self-governments are not prepared to enter into more complicated arrangements requiring tools, having no specialists available (especially smaller communities). Application of financial tools is decided according to individual cases. Almost no elaborate support financial schemes are applied e.g. in relation to SME's. The potential for more active intervention into LED processes is negatively influenced by the long-term financial scarcity of local self-governments.

Cities carefully design their tax/fees rates in order to protect their income bases and do not threaten the functioning of local businesses. Taxes/fees are selectively used for exemptions and abatements. The most typical local tax—property (real estate) tax is not used for extensive tax relief. More general schemes on tax/fees reduction are realized sporadically and on a short-term (one-year) basis. Normally, local councils adopt individual tax/fees holidays for a defined period for selected legal entities. They often prefer more cost–benefit based approaches, when exemptions and abatements in taxes/fees are compensated by certain developments (higher employment figures, larger investments). Some self-governments also accept postponing tax/fee payments during the initial period for certain companies. There are many companies with outstanding taxes/fees owed to the local budget. Local councils carefully investigate the reasons for these debts and in justified cases (e.g. documented difficulties) agree to an appropriate repayment scheme (postponement or graduated payment in installments). In exceptional cases, they agree to debt repayment via goods or services realized in favor of local self-government.

Municipal property is frequently used for the mobilization of financial resources as well as for creation of financially favorable conditions of LED. During the decision-making process, local councils take into account the needs of the local economy in addition to their own economic development objectives. They often decide on selling municipal property at favorable prices, or in more installments, reducing the capital needs of investors, or expansion of their investment project. Many cities also rent their own property, or agree on rent reduction according to the effect of activities on rented property. Local self-governments in many cases reduce rent in exchange for investment into their own property. They also accept long-term rent and interim rent reduction balanced by investments in public interests (e.g. technical infrastructure). Local self-government sometimes take into account the large development activities of certain companies in infrastructure as means of reducing their financial duties to local self-governments.

Local self-governments are able to finance certain development activities from internal resources. Capital participation in development projects, new companies, and associations is less frequent on a larger scale (e.g. in industrial parks, incubators). Loans for development activities or to companies with difficulties, as well as loan guarantees for development activities are rare forms of support. Local self-governments do not provide nor manage micro-loan programs. Local companies have a larger chance to obtain a contract from local self-government in the case of a smaller contract where more simple procurement procedures are applied.

For certain LED activities local self-governments also use external resources—commercial credit, or take loan guarantees for such activities conducted by their own municipal companies. Important roles have local self-government in accessing to central government development schemes, as well as EU funds or other governmental or international institutions, foundations and grant schemes. In many cases local self-governments had to manage economic development funding by combining the resources of many participants for financing one project.

The most frequent tax/fee and property based financial tools used by Slovak local self-governments include:

- tax- and fee-based tools
  - setting tax rates at a reasonable level
  - tax/fee abatement
  - tax/fee-free period
  - tax/fee-free period compensated by investments
  - tax/fee payment postponement
  - tax/fee debt covered in installments
  - tax/fee debt covered by work/services for local self-government
  - tax/fee penalty abatements/exemption/installments
- property-based financial tools
  - selling property at favorable prices
  - selling property in installments
  - rent reduction depending on activity
  - rent reduction in exchange for investment
  - long-term rent and interim rent reduction in exchange for investments
- financing local economic development include:
  - internal financing and mobilization of internal resources
  - contributions, subventions, and grants to local businesses or development institutions
  - capital participation in new companies/associations
  - loans
  - loans for development activities/help companies facing interim troubles
  - loan guarantees for development activities
  - contracts to local companies

- accessing external resources (domestic, foreign)
  - commercial credits and guarantees
  - government development programs (domestic, foreign)
  - foundations grants
- funding mix formation.

## 2.6 Local Economic Development Planning

Local self-governments extensively use their powers in local economic development planning. Most of them try to reduce the barrier between development related to absence or not enough flexible territorial planning documents. Some of them have actively adjusted their territorial planning documents for development purposes during the last years. They identified and delimited whole sets of development locations for various purposes, in addition to collecting information on infrastructure. Selected cities have prepared sectoral development studies (strategies, concepts) addressing particular development locations or important sectors according to local economic profiles. Frequently, local self-governments have elaborated more complex but short-term development documents. They are mostly political documents adopted by local councils for one electoral period of local self-government, identifying main development priorities or necessary investments.

Rare attempts for more explicit local economic development planning existed already during the 1990s. However, they can hardly be considered elaborated documents of local economic development planning. More executive and economic development-based planning has been expanding since the end of the 1990s. Local economic development planning will expand in the near future due to the legislation requirement to elaborate a *program of economic and social development of communities*.

Main approaches within development planning processes include:

- local economic development objectives included in standard territorial planning documents
- sectoral local development strategies and concepts
- short term local development strategies and concepts
- local economic development strategies/plans.

## 2.7 Local Self-Government Organizational Responses and Personal Leadership

Organizational, personal, and leadership capacities dealing with local economic development within local self-government are important factors especially in preparation and

implementation of local economic development policies. While in some cities, more or less unclear LED oriented structures exist, while in a growing number of cities specialized officials and organizational units have been formed. They communicate with the local business sphere in order to identify and satisfy their needs from the local self-government side and to assist potential investors. Successful local economic development stories also are accompanied by deep personal engagement of active leaders backed by well functioning organizational structures having good ties to the business sphere. This is especially the case of initiative mayors, or experienced professional managers working within local self-government.

In the case of local economic developments issues dispersed across various departments within a city office, local development issues are among the primary tasks they administered. Under such an arrangement, it is not a permanent and on the whole, a less efficient activity. Higher priority is placed in the appointment of officials addressing LED as a sole responsibility, or the formation of a specific LED-oriented organizational unit within local self-governments. Such officials often work across city office departments, trying to coordinate their LED-related activities. They analyze the situations in local economies, are involved in the elaboration of particular projects, and participate in the implementation of development projects or particular investments. The high priority accorded to local economic development is evident through the establishment of specific development-oriented commissions in some local councils.

Extensive personal involvement and the ability to take on leadership roles are among the key factors of successful LED. Leadership capabilities are strongly lacking in some localities, stagnating in others. Local economic development activities can hardly be considered a routine activity. Progress is dependent on the availability of local leaders possessing deep personal commitment, complex skills, creativity, and the ability to attract partners. We can find successful leaders among state administration officials, leaders working at local specialized bodies, as well as leaders from local business communities. Mayors play a crucial role, having a direct mandate from citizens, being respected and reliable representatives of the local community, and supported by the capacities of the local office.

Primary approaches related to field of local self-government internal organizational responses include:

- Local economic development issues are dispersed across various departments within city office.
- Selected officials deal exclusively with LED, or specific LED-oriented organizational unit are established.
- Specific commissions of local councils oriented toward local economic development issues are functioning.
- There is a sense of deep personal involvement and leadership in LED.

## 2.8 Local Institutional Environment Formation

Local self-government institutional involvement belongs to the most visible expression of their interest in LED. Their role in new institution building is positive, resulting in the diversification and specialization of development activities. However, from a national perspective, there are large differences. Although still in formation, the initiative and participatory role of local self-governments in each locality is unavoidable. Local self-governments are involved in many other institutions specialized in certain economic development activities established under full control of local self-governments or in cooperation with partners from other sectors. Although partnership principles are followed in this framework, relations among local self-government and other partners in local economic development are of various characters. Table 3 documents the existence of a rich and specialized institutional environment focusing on LED issues. Despite this, the efficacy of these institutions are a matter under discussion. Many institutions are not always easily accessible. Some of them are quite new, with reduced capacities, in the early stages of their core activities. They are also not accredited and staffed by inexperienced workers. Coordination, hierarchy, natural links, and effective communication among them are currently being formulated. The influence of local self-governments in institutional environment formation also has more informal and softer forms. The shaping of unwritten local rules and social practices in order to achieve positive influence on local economic development is not an easy task. Nevertheless, it seems that institutional efficiency, reliability, trust and transparency, also are behind the success of certain cities in LED. In summary, local self-governments have an important role in shaping the normative aspects of relations in their cities.

Institutions related to local economic development outside the central level:

### *Self-Government*

- local self-governments (or joint offices serving many self-governments)
- regional self-governments

### *Local state administration*

- district offices
- specialized district (or sub-regional) offices (e.g. agriculture)
- regional offices
- specialized regional administration offices

### *Public law institutions*

- national and district labor offices

### *Education and research institutions*

- secondary/vocational training
- private training/retraining institutions
- research and development institutes
- universities

*Public-private institutions related to local economic development*

- first contact points
- tourist information centers
- SARIO offices in regions
- advisory, education, and information centers (rural development)
- regional development agencies
- regional advisory and information centers
- business innovation centers
- business incubators
- planning and programming bodies

*Private subjects*

- Individual entrepreneurs/companies
- Financial institutions (banks)
- Developers, real estate companies
- Companies active in planning, consulting, advising

*Associations/interest bodies/voluntary third sector bodies/informal bodies*

- associations of local self-government (microregional, regional)
- business associations
  - regional chambers of commerce and industry
  - regional chambers of agriculture and food-processing
  - local associations of entrepreneurs/clubs of entrepreneurs
- other specialized third sector bodies—civic, education, communitarian, etc.
- local development clubs, local patriots clubs, etc.
- Euro-regional institutions (secretariats, councils)

The most frequent involvement of local self-government in LED is based on its direct activities (decisions adopted by the local council or mayor and tasks executed by its internal bodies). Local self-government uses separate organizations—information and advisory centers, business incubators, and development agencies. In order to more efficiently address certain fields of action, informal networking activities serve for less intensive, local self-government relations to other organizations/companies. They are perceived as an important communication tool for local economic development institutions and the local business sphere. Local self-government with partners from other sectors follow economic development tasks by means of less ambitious cooperation and mutual support relations that can take the form of short-term contracts, individual short-term support and inter-mediation in certain activities. Most current local economic development activities are based on more ambitious inter-sectoral, public-private partnerships. Private, as well as third sector partners are important to sometimes inexperienced, under-financed, often overloaded local self-governments. Forms of partnership include long term contracts/agreements, development projects, as well as various new joint

companies or associations. The largest problem is in attraction of potential partners into closer cooperation and partnership in this field in some localities. Local self-governments usually have important coordinating position, reflecting especially their competencies in planning and managing development, its organizational capacities and stability, as well as and primary interest in locality.

Local self-government institutional and organizational involvement in support and managing of local economic development can take various forms:

- activities of local self-government and its internal bodies
- activities of organizations established by local self-government
- networking initiated by local self-government
- cooperation and support relations
- non-organizational and organizational partnership
- activities of other legal entities within local self-government regulatory powers.

### 3. LOCAL SELF-GOVERNMENT INVOLVEMENT IN LOCAL ECONOMIC DEVELOPMENT —PROBLEMS AND POLICY RECOMMENDATIONS

Experiences, innovative approaches, and the success of many local self-governments in Slovakia confirm their potential in this field even under the existing framework. Nevertheless there is large potential for improvements leading to more efficient local economic development policies and their larger impact on local economies. While part of recommendations are internal issues of local self-governments, other address changes in central state activities or require basic legal adjustments.

The most acute problems related to local economic development in Slovakia are:

- large differences among localities in attention to local economic development
- local self-governments frequently participating on central state or international support schemes, but less active in developing own initiatives
- insufficient local self-government capacities (professional, financial)
- insufficient communication and cooperation among local partners.

#### *Local self-government capacity*

- Larger motivation for expanding local self-governments activities in LED should be reconsidered and applied. Active local self-governments should be rewarded. They should be not only motivated to participate in central state-initiated programs, but motivated to mobilize all possible capacities and potential.
- More professional local economic development activities are needed in the field of local promotion and marketing. Current activities usually address more simple



objectives (tourism, the local image) and do not sufficiently focus on identified LED priorities or target groups.

- Personal capacities addressing local economic development in local self-governments should be strengthened. Lack of own local economic development initiatives, as well as less participation in external development initiatives is also related to reduced staff in many local offices active in this field.
- The quality of local self-government professionals dealing with local economic development planning and management should be improved. There are not enough well-trained and experienced professionals working in this field. The presence of experienced professionals, familiar with this field strongly influences efficiency of local self-government activities in local economic development.
- Opportunities for well-established and more practically focused training in LED, as well as its planning, financing, and management should be improved.

*Local economic development initiatives combining central state and local self-government participation*

- Activities of the central administration should be more framework oriented, with less decision-making over concrete local projects. Central state institutions need not control the whole process. Its role should be oriented toward setting the basic framework and selection criteria. Decision-making over concrete projects could be decentralized.
- Reconsider the financing of many central state programs—most are poorly financed. A huge effort sometimes goes into the distribution of a small amount of resources.
- Central state initiatives should be more quickly and efficiently introduced into praxis, as well as regularly evaluated. The period from legislation preparation, through its adoption, detailed regulation approval, and final implementation is too long. Many programs are “symbolic policies” documenting the interests of the central state which in fact do not function well.
- Parallel or overlapping initiatives and their fragmentation should be suppressed, the number of programs reduced, e.g. by their concentration or combination into larger ones. Programs are often small, and require numerous management bodies with insufficient resources for distribution.
- Related procedures should be simple and clear; decision-making on selection of projects shorter; the extent of needed documentation reduced. Frequent changes in managing institutions, conditions, procedures, and financial rules should also be reduced. More information and well-trained advisors can lead to a larger impact.

*Local self-government finances*

- More financial resources should be available for local economic development in local budgets. A small amount of own resources and large dependence on transfers from the state prevent more extensive application of financial tools. Transfers from the central budget should be enlarged by an increase in shared taxes, as well as in a larger allocation of resources to local economic development programs.
- More freedom in local taxation and use of local property could strengthen the position of local self-governments in local economic development. Increased differentiation of local taxes and fees (higher upper limits) could allow more focused approach to local businesses. Larger freedom in use of local property transferred within decentralization could improve LED capacities and activities.
- More clear rules in financing local economic development can have positive impact. More precise strategies and rules of financial assistance adopted by local self-governments can serve LED in building trust between local self-government and local business sphere. Local self-governments also should reconsider establishing of more explicit grant schemes in support of local economies.

*Education, employment, and business*

- Local self-government and the local business sphere should have larger opportunities to shape the local education sector. Local self-governments could facilitate and support cooperation between the local education and business sectors. Such linkages should lead to more a localized education-sector profile. The labor office or local self-government initiatives (grants or subventions) could address companies that establish more direct links (e.g. practical training) to local schools.
- Employment strategies should be prepared for the local level as well. Although local self-governments are interested in the local labor market, possibilities of more efficient action should be considered. It could help develop more efficient active local labor market strategies elaborated according to local needs, with more local participants and more local knowledge exploited. They could influence, for example, priorities in retraining, public works, and expansion of such activities.
- Local self-government can contribute to simplifying the processes of business start-ups related to their regulatory powers. It could also provide basic business information and advisory services in the form of one-stop business assistance centers. Experiences with first contact points will be important in expansion of such services.

### *Local economic development planning*

- More elaborate local economic development planning under the control of local self-government is needed. Local economic development planning based on identification of priorities, with an approach oriented toward participation, implementation, and financing, generates greater effects than existing territorial planning documents. Besides local action in this field, external resources should offer grants supporting elaboration of such documents.
- Local self-governments should not be allowed to freely interpret the *Community Social and Economic Development Program*. It should be used as tool to introduce real local economic development planning. Brief guidance on such plans and relations to other plans should be defined in joint effort by related ministries, professional communities, and local self-governments.

### *Institutional environment serving local economic development*

- Location of support institutions should shift in favor of smaller centers with the participation of local self-governments. Besides founding their own institutions, local self-government should actively enter into the processes of state-initiated institutional location. Most of support institutions (RAICs, BICs, RDAs, and incubators) are located in larger urban centers outside economically depressed regions. They could be relocated to areas where their presence could support commuters.
- Local needs and core LED activities should be identified and linkages or hierarchy should be clarified in a case of growing number of LED-related institutions. While some institutions provide all services, others do not. The character and scope of services needed at the local level should be identified and institutionally covered. It could be less specialized offices in smaller centers, and more specialized agencies in larger centers (in contact with local agencies).

### *Transparency and democracy in local economic development*

- More information, communication, and participatory practices are needed in local economic development and development planning. There should be informal agreements on standardized information provided by local self-governments related to local economic development. More attention should be paid to transparency in territorial planning.
- More transparency and regular evaluation is needed in local economic development institutions with local self-government participation. Transparency and systematic evaluation, auditing, accreditation, and pressure for efficiency are not well-developed. Citizens are not well informed as to various affiliated organizations, including those active in LED.

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*Zákon č. 503/2001 Z.z. o podpore regionálneho rozvoja* [Support for Regional Development Act 503/2001 Coll.].

*Zákon č. 565/2001 Z.z. o investičných stimuloch a o zmene a doplnení niektorých zákonov* [Investment Incentives Act 565/2001 Coll.].

## NOTES

- <sup>1</sup> Although the unemployment rate in Slovakia decreased in August 2003 to 14.3%, there are still 19 districts out of a total 79 exceeding a 20% unemployment rate (National Labor Office).
- <sup>2</sup> For details on transfer of powers among particular level of government, see Act 416/2001.
- <sup>3</sup> As of 2005 local self-government can claim returnable resources only if total sum of debt to the end of budgetary year do not exceed 60% of real current incomes of previous year, and total sum of annual debt payments including rates do not exceed 25% of real current income of previous budgetary year.
- <sup>4</sup> Local self-governments usually adopted special regulation concerning information providing. Price of information provision covers only direct costs (usually copying, printing of materials, usually free of charge if delivered electronically or by phone).
- <sup>5</sup> Extensive overview of all activities in the field of SMEs development provides for example Support of Small and Medium Entrepreneurship in the Slovak Republic prepared by NADSME in 2002.
- <sup>6</sup> The basic rules are defined in the Act on School Administration and School Self-Government.



# The Role of Local Government in Local Economic Development

Ukraine

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### 1. LOCAL ECONOMIC DEVELOPMENT IN TRANSITION

Transformation processes initiated in Ukraine affecting its socioeconomic structure have led to decentralization of the government. The transfer of some responsibilities for boosting the population's living standards requires local executive authorities and self-government bodies to devise policy for stimulating or supporting local economic development in their areas.

The main goal of local economic development is to raise the standard of living for local populations by means of local resources, improvement of employment opportunities, and through the accumulation of aggregate wealth through business activity. Important objectives of local self-government in terms of economic development include creation of favorable conditions for entrepreneurship; establishment of institutional ties with other communities and territories, national and regional governments, businesses, and non-government organizations; improvement of the human and physical resources (infrastructure), and increasing the quality of work from public institutions.

Local economies are influenced by external factors, including state and regional economic policies, as well as laws and decrees of executive authorities at all levels. One of the objectives of local self-government is to be able to efficiently and promptly minimize negative external impacts on the community, as well as to take advantage of opportunities that arise.

In Ukraine, formation of local economic development—both as an idea and as a process—have passed through a very difficult time, characterized by profound changes aimed at creating local economic development patterns inherent in other European countries.

Historically, Ukraine had a prosperous peasantry and adhered to the medieval system of Magdeburg Law that was widely applied in Western and Central European regions. During the 20th century Ukraine experienced the most extensive damage to local self-government foundations among all the Soviet-bloc states; the destruction affected communities, property, traditions, and decision-making capacity.

The effects of the damage continue even after the first decade of Ukrainian independence. The main difficulties experienced by local economies in Ukraine with regard to development are as follows:

- Ukraine does not have a sufficient social, economic, and regulatory basis for development of self-government or local economies.
- There are serious declines in regional economies that had been victims of planned economic management and of the former focus on the military production sectors. Today, the majority of Ukrainian regions would be classified as depressed, according to European criteria. This means that regional development needs to be considered in the context of overcoming significant transformation-era declines.
- In Soviet times, regional development was based on the planned and centralized allocation of production facilities with concomitant supply of labor and inputs. Long-term state plans for workforce allocation and settlement were the determinant for citing large industrial production plants, and for the construction of new settlements. Settlements excluded from this general plan were considered to be “unpromising” and were sentenced to destruction. This kind of planning absolutely ignored the interests of individual local communities, including natural resource usage and environmental protection, not to mention the preservation of cultural features and husbandry traditions. This rigid system of planning, distribution, and control did not leave any space for initiatives or changes at the local level.

The top-priority objective of local economic development as a part of overall local development in Ukraine is to learn how to think about development—not in the general categories of ideal territories being units of the central management system, but to consider individual territories and local communities as parts of a single whole.

It is necessary not only to support regulatory laws that enable local development while facilitating change in public administration; it is vitally necessary to support renewal processes within the deep foundations of local development. These processes are of a much greater scale than mere implementation of measures aimed at creating favorable conditions for local economies.

## 1.1 Legal and Administrative Environment of Local Government

During the transition period, Ukraine applied various models of governmental organization, reflecting different stages of decentralization: starting from a Soviet-style administrative system of direct state government at the local level (up to December 1990) to an attempt to introduce absolutely decentralized government (February 1994–June 1995) when the state executive authorities were abolished at all local levels and their functions were handed to the executive bodies of local self-government.

Currently, the system of public administration in Ukraine is regulated by the Constitution, the Law on Local Self-Government (1997), the Law on Local Administration (1999), and the Law on the Capital of Ukraine and the city of Sevastopol (1999).

Ukraine has a three-tiered system of elected representative bodies (*oblast*, *rayon*, and town/village or city district) that are independent of each other.<sup>1</sup> At the same time, the executive branch is represented by state administrations, which are completely hierarchical from top to bottom; *rayon* and city state administrations are subordinated to *oblast* state administrations, which in turn are subordinated to the central government. *Oblast* state administrations are appointed by the central executive and granted the authorities of executive bodies of *oblast radas* (councils) of people's deputies. The fact that local self-government actually does not have its own executive bodies causes many contradictions and hinders the development of a full-fledged self-government system.

In practice the public administration system and the state finance system in Ukraine are still highly centralized. Although the necessity of reforming the current system and moving to decentralization are recognized at both central and regional levels, principles of territorial autonomy have not yet been introduced.

The Constitution ensures the basic foundations of local self-government, and at the same time the Constitution also empowers the central executive to take and implement decisions at the local level (in *oblasts* and *rayons*). This is one of the main problems of local self-government development in Ukraine. In cities and towns, local self-government bodies are elected by the people and have corresponding executive bodies. As a result, the democratic system has started to operate at the local self-government level. However, there is continuing ambivalence about the role of the central government at the local level.

Ukraine has ignored, or not yet completed, the necessary reforms that would improve legitimate democratic cooperation between central and local governments. The partial reforms of the legislative and executive arms of government separate functions between local self-government bodies and cause uncertainty and incapacity in the entire system. The powers and authorities of government officials remain unclear and often duplicate each other. There is no clear enforcement mechanism regarding the division of roles and responsibilities between local executive and legislative bodies set in the laws. There

are overlapping functions and unclear responsibilities that complicate the work of and cooperation between authorities at different levels. There is no clear definition of which bodies provide what services and which arm of local government (the state administration or the local *rada*) fulfills which functions. This situation makes local government much less effective and depresses local economic development.

## 1.2 The Economic Environment for Local Economic Development

Local economic development in Ukraine is taking place in a difficult macro-economic environment, though one that is showing signs of improvement. The Ukrainian economy declined steadily after independence, with GDP in 1999 only around 50 percent of the 1992 level and lower performances than in other NIS. After Ukraine started to apply stabilization measures, (from 2000) the region enjoyed the first reversal of the negative growth trend. GDP grew by almost 6 percent, industrial production by 13 percent, and gross agricultural output by 9 percent. Results from 2001 confirm that economic growth in Ukraine continues. It is assumed that it is mainly caused by increase in production in traditional branches of heavy industry and the return of capital, previously exported from Ukraine, due to improvements in the business climate. The continuation of this positive trend is, however, uncertain. Major obstacles to sustained growth are the incomplete structural transformation of the economy, including the weak banking system, and the still unpredictable investment climate, with ambiguous laws that are arbitrarily enforced. The economy still suffers from a lack of functioning market institutions and weak legal protection and there are many barriers to foreign traders and investors.

Industrial equipment (in the energy sector in particular) transport infrastructures, social infrastructures (health, education, social services) have not been renovated during transition and are in steady decay. Shrinking budgetary resources and an unclear definition of responsibilities have led to deterioration in social service delivery. The framework law on social protection has now prepared the ground for the establishment of a sustainable system of financing social and health care services in the country.

Living standards have fallen dramatically in Ukraine during the whole period of the 1990s. The incidence of poverty has increased considerably to the point that 27 percent of the population is now believed to be below the poverty line. A fifth of the population is working part-time or is on administrative leave and formal unemployment has risen to 11 percent. The drastic decline in social benefits has also resulted in a high proportion of households living in extreme poverty.

After the collapse of the old social protection system, mainly due to financial constraints, Ukraine has only made tentative steps towards the establishment of a modern delivery system of social and health services. Governmental services have not

systematically adapted to meet the changes. The significant deterioration in health and social indicators confirms the need to address the problems of vulnerable groups such as children, the disabled and the elderly.

Ukraine is a rather heterogeneous country from the viewpoint of traditions of self-government, economic development, and international relations. We identified a small number of local economies and local governments, in order to get a reasonable picture of conditions and trends in local economic development.

The following division of Ukraine into groups of local economies with similar indicators of economic development can be used:

- north: Chernihiv, Kiev (excluding Kiev City), Sumy, and Zhytomyr *oblasts*
- south: the Autonomous Republic of Crimea, along with Kherson, Mykolaiv, and Odessa *oblasts*, and Sevastopol City
- center: Cherkasy, Kirovohrad, Poltava, and Vinnytsia *oblasts*
- west: Chernivtsi, Ivano-Frankivsk, Lviv, Khmelnytsky, Rivne, Ternopil, Transcarpathia, and Volyn *oblasts*
- east: Donetsk, Dnipropetrovsk, Luhansk, Kharkiv, and Zaporizhia *oblasts*
- the City of Kiev.

*Table 1.*

Major Socioeconomic Development Indicators for Ukraine's Regions

Indicators	Kiev	East	North	Center	South	West
Gross value-added per capita (2000), UAH	5,969	3,254	2,620	2,443	2,326	1,954
Gross value-added per capita rating (2000)	1	2	3	4	5	6
Population (2000) [millions]	2.6	16.2	5.9	6.1	7.5	11.2
Unemployment rate (2001, by ILO methodology) [%]	6.1	10.7	13.4	10.7	9.6	13.0
Industry in gross value-added in 2000 [%]	16.4	48.2	28.3	28.5	23.6	23.8
Services in gross value-added in 2000 [%]	73.9	38.3	37	38.7	51.5	42.9
Agriculture in gross value-added in 2000 [%]	—	10.1	30.5	28.3	19.9	28.8
Privatized enterprises (as of YE'01) [%]	13.0	27.6	29.2	25.6	25.2	37.7
FDI per capita (as of YE'01) [USD]	585	68	84	48	66	42
Average household spending (2001), UAH	846	508	459	418	478	453

*Source:* State Statistics Committee; calculations by ICPS.

If we assume the volume of gross valued-added per capita to be the sole indicator of economic development, then the City of Kiev emerges as the absolute leader among the regions, while the Western Region comes in last.

Almost all economic development indicators of the City of Kiev are the best among the regions. Kiev's leadership owes much to its status as Ukraine's capital, as well as to the high competitiveness of its economy.

The Eastern Region maintains second place due to its developed industry, the share of which in the regional economy is the highest in Ukraine. The development of industry keeps unemployment in the region at a low level.

The Northern and Central regions are in third and fourth place. The economies of both regions are similar in structure. However, the Northern Region holds third place largely thanks to the high level of economic development of Kiev *oblast*, a result of its close economic bonds with the capital.

The economy in the Southern Region is dominated by the service sector. Nonetheless, this indicator did not allow the region to climb higher than fifth place by the volume of gross value-added per capita,

The Western Region occupies last place. The second-largest region by population, this part of Ukraine is characterized by a high unemployment rate and small investment volumes. The economy is dominated by the service sector, which has been slow to develop and has low labor productivity.

## 2. FACTORS SHAPING THE ROLE OF LOCAL GOVERNMENT IN LOCAL ECONOMIC DEVELOPMENT

### 2.1 Authorities of Local Government

The scope of authority and responsibilities of local governments is stipulated in the Constitution of Ukraine, the Law on Local Self-Government and other legislation. It varies depending on their level, from the resolution of issues of local significance to the execution of tasks delegated by higher-level bodies. Local issues are resolved mostly by municipal, village, and town councils, while regional planning is the domain of *oblast* and *rayon* councils.

Under the current law, local self-government bodies as well as local administrations of the central executive authority have their own and delegated authorities and responsibilities. The law provides for a list of own and delegated authorities and responsibilities in the following functional spheres:

- economic, social, and cultural development planning and accounting
- finance, budgets, and price regulation

- usage and management of communal property
- housing, public utilities, local transportation
- capital construction
- education, health care, culture, and sports
- usage of land and natural resources, and protection of environment
- social security of the population
- foreign relations
- national defense
- certain issues of administrative-territorial units
- law enforcement and protection of the people's rights, freedoms, and interests.

The law also determines administrative framework for the functioning of local government: composition of representative and executive bodies of local public administration, scope of authorities and responsibilities of representative and executive bodies, relations between them; management of local government bodies, procedures for decision development and approval, reporting, and control.

Existing legislative frameworks do not always correspond to the new role under transformation for all aspects of activities practiced by local government bodies, particularly in regard to local economic development. Although over the years of independence Ukraine has made a breakthrough in designing and adopting legislative acts which establish grounds for local government—business interaction, there many problems remain in this sphere. Fundamental issues such as what the responsibilities of local self-government bodies should constitute and what resources the execution of their authorities should be provided with have not yet been resolved. The absence of answers to these questions sparks many conflicts between local governments and entrepreneurs.

## 2.2 Economic Basis for Local Government

The existing legal framework for local government and self-government in Ukraine includes the provision of financial basis for implementation of their defined authorities and responsibilities. Finances of local self-governments include local budgets and non-budgetary funds.

The impact of fiscal policy upon local economic development is crucial. The budget system is the most important factor in the formation of a sufficient financial base for local government bodies, which in turn is central to adequate motivation for building cooperation with businesses (or stifling their development).

The law defines the following sources of formation for local budgets and non-budgetary funds: tax revenues, non-tax revenues, local borrowing (own sources), and

inter-budgetary transfers. Nowadays, the revenue base of local budgets in Ukraine is insufficient for execution of the authorities designated to them. Consequently, local government bodies resort to semi-legal ways of obtaining additional financial revenues, exerting pressure over local business structures and thus hampering economic development.

The budgetary system in Ukraine is regulated by the 2001 budget code. Adoption of the budget code created the foundation for the clear and stable functioning of local budgets. In particular, tax revenues were fixed for local budgets of all levels, with a specific list of taxes and ratios of revenues from them intended for each level; Inter-budgetary relations were clearly determined: formula approach to calculating inter-budgetary transfers was stipulated, separate calculation of transfers for each level of the budget were introduced. It enabled local governments to develop their financial strategies in a relatively certain and predictable framework. Despite its progress, the budget code still has a number of problems that will need to be resolved in course of development of local government in Ukraine.

### 2.2.1 Fixed Revenues of Local Budgets

Under extant legislation, fixed revenues determined for budgets of all levels in Ukraine include the following:

- certain portions of national tax revenues (taxes, levies, and fees imposed and regulated by the state)
- local taxes and levies (taxes and levies imposed and regulated by local governments according to their jurisdiction within the bounds stipulated by the national law)
- non-tax revenues (including proceeds from the rent and sale of communally-owned property, including land plots not designated as agricultural, portion of profits of communally owned enterprises, profits from operations on capital markets, etc).

Fixed revenues for local budgets in Ukraine are unable to ensure sufficient possibilities for community development. Due to a weak base for their own proceeds, local government bodies set the highest possible tax rates. Thus, the main goal of local government bodies is to replenish the budget, not to foster territory development.

### 2.2.2 Inter-budgetary Relations

The existing relations between budgets of different levels are among the macro-economic factors having the biggest impact upon local economic development. The structure of



the existing budget system corresponds to the administrative-territorial division of the state.

The total amount of fixed revenues accumulated in local budgets constitutes a rather small part of the country's GDP and combined national budget. Therefore there is a need for reallocation of a part of funds from the state budget to local budgets. This reallocation is done in the form of inter-budgetary transfers.

As the levels of economic development of different communities in different regions show substantial disparity, so do the sources of fixed revenues of local budgets. Usually the volume of revenues is not directly related to the population of a community but to the volume of specific responsibilities assigned to them; therefore the difference of per capita revenues of budgets of the same level may reach 3 to 1. The system of inter-budgetary relations is aimed at correction of interregional differences in the level of provision of population with social goods and services, such as pre-school education, healthcare, and development of transport infrastructure, and implementation of specific functions of national importance.

Over the recent years in Ukraine, a formulaic approach to the calculation of inter-budgetary transfers was used. The adoption of the budget code in 2001 was a serious step forward, promulgating a list of revenue sources and designating expenditures that are the responsibility of budgets at all levels.

### 2.2.3 Exercise of Property Ownership and Management by Local Government

Ukrainian legislation states that local self-government bodies manage and dispose of communal property (enterprises, organizations, institutions, and land). Territorial communities owning communal properties can perform any economic operations with objects of communal property. The management of territorial ownership is executed by the executive bodies of local self-government.

Management of communal property is not properly regulated; specifically, the process of separation of state and communal property is still ongoing. Since the issue of ownership is not strictly defined, it is still unclear who has the right to dispose of it—local government bodies or the central one.

#### *Land Code*

Land management is one of the most burning issues stifling the development of entrepreneurship in Ukraine. The impossibility of getting ownership of land in the city was often the only argument against purchasing immovable property and investing, and the chief reason for valuable land plots not purchased. The land code enacted in 2002 was aimed at resolving this problem.

The land code offered more opportunities to Ukrainians and foreign citizens, legal entities and individuals, as well as individuals with no citizenship. Most importantly, the document officially proclaimed the possibility of free land sales. It should be noted that the code envisions the process of the land market formation taking up to eight years.

Together with the legislation for local self-government, the land code and its supporting regulations form the statutory basis for ownership, management and disposal of this ultimate natural resource by local government in Ukraine. However, its practical implementation revealed a number of issues that need to be further fixed in order to enhance its positive effect on local economic development.

## 2.3 Capacity of Local Governments for Economic Policy Formulation

In the context of social transformation, local economic development is directly related to the capacity of local self-governments to determine and preserve their own interests through their capacity for democratic policy and decision-making.

This suggests that there is a necessity to develop institutional capacity for strategic planning, for development of public policy documents, and for maintaining public dialogue and taking charge of change management.

The capacity of local governments to develop an effective policy of local development is defined by the existing standards and procedures of political decisions development that would take into account the interests of all stakeholders, in opposition to the Soviet era in which the only legitimate interests were those of the central powers and their institutions. As a consequence, today neither the central nor local authorities, businesses, nor local communities have the skills or experience to efficiently implement local economic development. Moreover, one of the conditions for effective governance is the availability of skills and knowledge to work under conditions of scarce resources and constant change.

Building this capacity constitutes the main stage of creating the opportunity for local economic development in post-totalitarian societies like Ukraine. The formation of corresponding institutions and skills provides criteria for social transformation alongside the criteria of economic development. As a direct and rapid impact of social transformation processes on economic indices is impossible, then the formation of new order in its first stages might be accompanied by a slowdown in economic development, compared to former command approaches to management of the economy.

The institutional capacity of local governments for making effective policy towards local economic development in Ukraine is in most cases mediocre. Improvement of this capacity remains a crucial factor for effective local development in Ukraine, including economic development.

### 3. THE POLICIES OF LOCAL GOVERNMENT BODIES TOWARDS LOCAL ECONOMIC DEVELOPMENT

Until recently, the regional policy of Ukraine regarding the promotion of local economic development, for the most part, only had the real form of free economic zones. Unfortunately, these zones were not founded based on thorough analysis and were created in both economically strong and weak regions, so the results are far from what was anticipated.

At this stage, Ukraine is developing a strategy of state regional policy aimed at supporting depressed territories. The strategy's goals are to close the gap between different regions and relieve social tension that may otherwise accumulate in less developed territories. Ukraine's state regional policy will be tailored to allow individual regions to make full use of their economic potential.

We define two major ways by which local governments can stimulate local economic development:

- improvement of local environment for investors and development of local business
- development of business infrastructure and increasing the quality of public services delivered to businesses.

The Ukrainian experience includes a variety of policies undertaken by local governments with the purpose of achieving these strategic goals.

#### 3.1 Promoting Local Business Development

By its nature, local business is regionally oriented, so planning is based on the needs and opportunities existing on the local market, as well as the size and structure of local demand. Under present conditions of developing Ukrainian regions' economic independence, local business is an important factor that, in a favorable environment, acts as a potent catalyst for structural optimization of a region's economy, and for decreasing poverty and unemployment in the region.

Local governments are motivated to promote local business development by the opportunity to raise local budgets' revenues. However, because tax revenues are centralized and local budgets subsidized, local governments do not experience a direct relationship between budget revenue levels and business development in their regions so they are not really motivated to promote business development. More often they rely on the short-term income that comes from providing services, leasing property, collecting fines, and raising local taxes, and goes directly to the local budget.

Research on the problems faced by local businesses in Ukraine have been conducted over a period of several years. As a result, the following major issues can be identified:

- high tax rates set by local governments
- excessive administrative pressure
- frequent and/or stringent audits
- costly permits (in terms of time and other resources)
- red tape in the lease and purchase of non-agricultural land
- red tape in re-registering premises as non-residential
- obtruding services
- unfair competition.

These issues become priorities in policies for fostering local business development.

### 3.1.1 Regional Business Development Programs

In accordance with the Law on State Support of Small Business, regional small business development programs are the main tools of state policy for local business development. The law sets the principles of drafting, funding, and approving regional small business development programs (hereinafter referred to as “regional programs”) and gives local self-government bodies the powers to approve them (before that, these powers belonged to local executive authorities). Regional programs mainly focus on improving the legal framework of small business, ensuring financial support of and investment in small business and creating and improving the infrastructure for supporting small business.

The specific list of measures is determined by government bodies annually, and as a rule it is based on the results of consultations and discussions with local entrepreneurs. Local government bodies independently determine the sources for financing program measures, the key ones being local budgets, national and regional funds promoting entrepreneurship, regional employment centers, bank loans, proceeds from the privatization of state property, foreign investments, international foundations, as well as own money of executors of particular projects and sub-programs. The execution of measures is delegated to corresponding divisions or departments of local government bodies, or local entrepreneurs selected by public tenders. The desire to adopt a program approach to small business development is present at the *rayon* and city levels as well.

### 3.1.2 Regulation of Local Tax Rates

An effective instrument of facilitating local entrepreneurship is regulating local tax rates and extending benefits by local government bodies. The tax rates are usually set based on

the results of discussions and consultations with local associations of entrepreneurs.

It should be noted that collection of local taxes and control over their payment is imposed upon the state (national level) tax agencies that are not accountable to local government authorities. Due to obsolete legislation dealing with local taxes and levies, many provisions need to be regulated by decisions of local councils. On the one hand, such a situation may prompt local governments to adopt business-stimulating decisions, but in practice the deputies to local councils fear to undertake any independent actions, or are forced to do it under pressure from the tax authorities.

For several consecutive years there have been heated debates concerning local levies. In reality some of them acquired the characteristics of a tax collected on a regular basis. Taking advantage of the vagueness of the legislation, local councils seek to replenish budgets but instead create obstacles for business development.

Simultaneously, there are better examples of effective decisions having resolved problems of local development by setting tax rates and levies which pertain to the competence of corresponding local governments. For example, in order to spur business activity differentiated rates for trade patents are reviewed and re-set at the local level.

### 3.1.3 Reducing Administrative Pressure

The critical point to launch the entrepreneurial activity is state registration as an entrepreneur to receive the license to implement certain kinds of entrepreneurial activity. The body of state registration is local government, it also provides entrepreneurs with certain kinds of licenses. Administrative pressure by local governments includes bureaucratic hassles with regard to licensing and audits and remains a major problem hampering local business development in Ukraine.

The findings of different surveys prove that every year registration of businesses becomes less and less problematic compared to other regulatory procedures such as license administration. The biggest success of local governments in bringing down administrative barriers to business development was the creation of what is called “common offices.” When all licensing authorities are in the same office, it is easier to register new businesses and more resources become available to diversify existing ones. Another model used was creation of a single service to apply to for all permits involved in obtaining licenses. This model can reduce opportunities for corruption and increase efficiency far better than the “common office” model.

Polls conducted by the International Finance Corporation reveal that the number of audits while having decreased on average in the last three years, remains too high, so businesses do not feel any relief. More than thirty state bodies conduct audits, particularly tax administration, fire inspection, sanitation service, etc. A persistent tendency of local governments to formally violate audit procedures was even established in the

Presidential Decree “on certain measures to deregulate entrepreneurial activity” (1998). For example, a limit on the number of routine audits has led to more unplanned ones to which there is no limit in the decree. This causes huge losses in time, efficiency, and trust in the government.

Violation of competition has become widespread because of existing preferential treatment for firms controlled by certain politicians or affiliated individuals. This preferential treatment takes place on different scales and employs different instruments—from decisions of local councils in favor of certain entities to issuing permissions for installing or renting premises at privileged tariffs.

Another form of administrative pressure is the system of imposing administrative services that have to do with obtaining permissions. For instance, in order to receive permission to commence work in specific premises, it is essential to take (and pay for) special courses on fire protection. This is a form of legal extortion (because the requirement to pass courses is fixed in the by-law) that replaces bribes. Because it is a legal requirement, it is considerably easier to limit the size of the fees involved.

In this case local governments must be active in detecting such instances and take all complaints to the central executive. Here, local governments should perform its function of protector of entrepreneurs.

### 3.1.4 Leasing Premises to Businesses

The majority of businesses, especially small ones, do not own immovable property but use the communal premises of commercial spaces on rental rights. Such a situation was caused by monopolistic status of local government on the market of immovable property in the sphere of commercial space. As a result, local governments are one of the most effective instruments to further the development of local business is the possibility to rent and to sell of communal property to the entrepreneurs.

Research indicates that the biggest problem for businesses is the reluctance of local governments to enter into long-term leases. Local governments force businesses into leases with a term of 2 or 3 years, and when they want to extend them, they have to pay money to various “charity accounts” controlled by the government. Thus businesses have no motivation to invest into renovating communally owned buildings and premises. Another problem is high rent especially burdensome for small businesses that cannot buy the premises.

Introduction of new regulations on land ownership and usage simplified the purchase of non-agricultural land for business purposes. Businesses that have the necessary funds are now entitled to purchase the land of their choice.

### 3.1.5 Providing Information that Businesses Need

Business development would benefit greatly from ready availability of information about licensing conditions, the hours of the various departments of local executive agencies, and the services they provide. For example, getting a construction permit to build business premises requires collecting many different permits from different agencies. Local governments can substantially improve the situation by making the information about the procedure for obtaining each of the permits, how much time it takes, what services it involves, and how much they cost available on information boards at their offices.

If information were available, businesses would be able to find vacant communal premises and land plots. One way to do it is to place a terminal with a database on premises and land plots for sale and lease at the city executive committee where businesses can access it.

### 3.1.6 Fostering the Creation of Business Infrastructure

An important instrument for local government is the facilitation of activities by entities that belong to the infrastructure of small business development, in particular, business centers and business incubators.

Nowadays, the majority of entities of business infrastructure emerge either spontaneously or in connection with foreign technical assistance or as a reaction to the needs of business associations or initiative groups. The role of local government bodies lies mostly in the provision of premises, necessary consultations, and involvement of employees of business centers and business incubators in performing budget works on a bidding basis. Additionally, the practice of local government bodies providing guarantees against projects being designed by business centers is gaining popularity.

Donor-funded business incubators have been opening in Ukraine for some time now, and some of them have become self-financing. They vary in structure and provide a great multitude of services. They also have an inconsistent relationship to local governments; this can cause difficulties for businesses as local governments have been known to unpredictably raise rents and conduct unscheduled audits. Finance and credit support for business

Major objectives and tools of finance and credit support for local businesses by local government bodies are stated in regional programs promoting the development of small business. According to the programs, financial support is extended at the expense of money of local budgets, existing specialized funds, personal money and international financial organizations

For local government bodies, key sources of financing measures aimed at supporting local businesses are regional business development funds, which use the money of

local budgets, associations, communities, charity organizations as well as businesses. In order to finance investment projects of business entities local government bodies attract money from international financial organizations, namely: the European Bank for Reconstruction and Development, the Western NIS Fund, the Eurasia Fund, Ukraine Investment Fund, International Finance Corporation (IFC), and the United State Agency for International Development (USAID).

Another important tool employed by local government is the credit support program for small businesses. The introduction of micro-lending has been discussed for five years. The primary issue impeding micro-lending is a lack of legal framework for non-bank micro-lending, but local governments could make a contribution by starting to work with banks on this matter. One positive example is the creation of mechanisms for business loans with guarantees and partial interest payments from local government. Funds allocated to this program would be used to pay a percentage of the interest on loans provided to small businesses by banks.

Another viable financial tool of supporting local enterprises is government procurements. However, information about communal contracts is almost unavailable for businesses. The *Public Contracts Bulletin* runs occasional information about contracts offered by local governments, but this is an exception rather than the rule. Owners of small and medium businesses practically do not see communal contracts as real opportunities because they do not expect to be treated impartially.

### 3.1.7 Investment Development Programs

Transition economies with a deficit of private and government investment such as Ukraine need foreign investment the most. A country's investment climate and rate of economic development depend on the quality of decisions and the government's ability to foresee their impact. Ukraine, unfortunately, remains a country with few incentives to invest and low investment transparency, which limits the amount of investment that it receives.

The central government's first initiative to use a strategic approach to stimulating investment was the 2002–2010 Investment Development Program<sup>2</sup> created following the requirements in the Presidential Decree “on measures to increase investment in Ukraine's economy,” that identified a good investment climate as a key priority for both the central and local governments.<sup>3</sup> Moreover, local governments were also charged with the task of improving investment climate.

Unfortunately the program does not provide any specific implementation measures and criteria. Moreover, the political risks associated with the 2004 presidential elections, as well as a limited budget, make the success of this ambitious program unlikely.



Only three of Ukraine's twenty-five *oblasts* have their own local investment development programs, but these programs are responses to the central government's demands rather than real local initiatives. The lack of understanding of the role of local governments in creating a good investment climate in their region is evidenced by the low institutional support of investment.

In most of Ukraine's *oblasts*, investment matters are the responsibility of subdivisions of the chief economy departments of *oblast* state administrations. Their main task is implementing state investment policy so they often have no idea of their own, regional investment policy.

### 3.1.8 Free Economic Zones

In our opinion, a possible reason of the inadequate understanding of the role of local governments in promoting investment in Ukraine is the existence of free economic zones (FEZs)<sup>4</sup> and priority development territories (PDTs).<sup>5</sup> The main goals of FEZs and PDTs are attracting foreign investment, creating jobs, increasing foreign trade, and promoting innovations.

Most FEZs and PDTs have various tax and customs benefits. The largest number of FEZs and PDTs were created in 2000–2001 despite serious doubts among economists as to their effectiveness in Ukraine. Driven by the false idea that special treatment will solve the region's problems, lobbyists are trying to get FEZ or PDT status for their regions. Moreover, no substantial expenditure from local budgets is necessary to get the status,<sup>6</sup> and the responsibility stays at the central level.

In reality, the share of foreign direct investment in FEZs and PDTs in Ukraine's total is critically small. The fact that FEZs and PDTs have practically the same sectoral structure as the investing countries means that it is not the special regulations that attract the investors.

### 3.1.9 Creating a Positive Investment Image

Local governments must use their best efforts to create a good investment image of their regions and ensure the necessary institutional support of the investment process. In order to establish an effective dialogue between stakeholders, local governments should create local investment centers. Broad participation of prospective stakeholders in the development of investment would encourage diversified and innovative approaches to dealing with regional problems and creating new opportunities. Such investment centers must be independent and able to provide investors with all the necessary information about regional resources and investment opportunities, as well as with registration assistance

and advice. They also must develop ties with foreign investors and market the region, through setting up web pages, organizing forums, exhibitions, etc.

Another important task for local governments is promoting the re-investment of profits in the regional economy. This includes creating market-based incentives, a transparent environment and good image, as well as ensuring the proper functioning of financial institutions.

## 3.2 Investment in the Development of Local Infrastructure

One of the essential areas of supporting and fostering business is improving infrastructure, which includes:

- built-up areas with a proper level of architectural development, as places of residence and of doing business
- land which is at once both a medium of and a place for installing offices or houses
- transport and infrastructure of transport connections, as a tool of galvanizing economic activity of businesses.

Facilitation of local self-government bodies per se implies effective allocation of available resources and tools for infrastructure improvement of business activity.

### 3.2.1 Built-up Areas

Local self-government bodies have certain powers concerning urban planning on their territory that include determining territories, reserving (buying out), and providing land for urban planning needs, in accordance with legislation, and approving regional and local urban planning programs and general urban planning schemes. This enables them to set priorities in the development of different territories and to channel investments. Unfortunately, local governments cannot take direct part in investing due to their limited budgets. However, they have rather wide powers to establish the rules for developing towns and villages.

Local self-government bodies coordinate the efforts of entities involved in urban planning aimed at the integrated development of settlements. This coordination works as follows: the city executive committee's chief architecture department commissions developers to prepare project documentation and announces construction tenders. Construction may be funded by:

- designated-purpose transfers from the national budget for the construction of specific objects of national or regional jurisdiction (such as an *oblast* hospital)

- local budget funds approved and allotted by the local council for new construction or reconstruction (such as reconstruction of the old city center)
- borrowed funds of investors, who can be individuals or entities.

Other urban planning powers that local governments possess include examining and approving urban planning documentation; organizing the creation and maintenance of an urban planning cadastre of population centers; issuing urban planning orders to developers, in accordance with established procedure; the construction, reconstruction, and development of specifications and permits; and organizing the protection, restoration, and use of architectural and other urban monuments and natural landscapes.

### 3.2.2 Land Lots

According to the newly adopted land code of Ukraine, allotting land lots is a one-stage process. This means that preliminary agreement is required only in the case of impressments of the land lot from another user. In practice, however, besides the decision of the appropriate authority it is necessary to obtain a document certifying the right to land use (the state land title or land rent certificate). The current procedure of attaining permissions for land use and new project launching is inappropriate for entrepreneurial groups due to its complexity, opacity, and slowness. It is advisable to simplify these procedures.

The rules for territory usage and development adopted by local governments are obligatory for all proprietors of land including buildings and structures on that land, and for bodies controlling the implementation of communal construction, design, exploring, repairing works, and communal services, as well as other procedures within the field of competence covered by the rules. Development and implementation of such rules is impossible without a geo-informatics system (techniques and urban development maps). These allow not only increased efficiency and grounds for established limitations on land lot usage but also promote information searches and analytical models for urban environment regulation.

### 3.2.3 Transportation

Local transportation plays a great role in the life of Ukrainian cities, towns, and villages. On the one hand, it provides mobility for the local population within the inhabited area; on the other hand, it facilitates local economic development. Local transport infrastructure includes both transportation vehicles (buses, trolleybuses, trams, and subways in big cities like Kiev, Kharkiv, and Dnipropetrovsk) and local roads. The service quality depends equally on the quality of the transport vehicles and on the road quality.

The following are key issues of transport services in urban settlements of Ukraine:

- growing traffic intensity and increased physical load on the road surface
- negligence of the rules of the road, and increasing numbers of accidents
- complexity of traffic streams and limitations on the qualitative regulation of those streams.

Insufficient funds of local budgets allocated to the maintenance and development of transport networks prompt the demand for broad involvement of private investment. Under these conditions, local authorities should preserve only controlling functions, in order to monitor compliance with regulations and transportation rules as well as the technical conditions of vehicles and drivers' qualifications. Many Ukrainian cities have initiated projects aimed at the improvement of transport services and increasing service quality in the sector.

### 3.2.4 Renovation Programs for Communal Land

One result of the aforementioned issues is the problem of investor involvement in the implementation of local territory renovation programs. A similar practice is widespread throughout the world; unfortunately, however, both practice and legislative regulations for this issue in Ukraine are lagging behind the global trend. For example, the Law on Local Self-Government enables local authorities to approve a list of territorial categories, reserving and allotting land for urban development purposes and renovation programs and establishing procedures for special use of land and build-up in definite territories where prospective city-development and land-development activity is envisaged.

Under conditions of insufficient funding, territorial development is financed through the involvement of land lot users. There is a widespread practice of developing territories adjacent to land objects sold at auction or rented, on the account of buyers or holders.

## 4. FUTURE ROLE OF LOCAL GOVERNMENT IN LOCAL ECONOMIC DEVELOPMENT

### 4.1 Improved Policy making by Local Governments

As discussed in the previous section, local governments in Ukraine have employed various approaches and policies aimed at stimulating local economic development. In

the context of societal transformation the development of the local economy is directly connected to the capacity of the local government to identify and defend its interests through ensuring a democratic decision-making process. In order to achieve this, it is necessary to develop the institutional capacity of local government in strategic planning, public policy documents development, public dialogue, and change management.

One of the dominant problems of local economic development is increasing public administration effectiveness according to the democratic principles of responsive and accountable policy development and implementation by local governments. In the system of local government key components of policy decisions development and making should include the discussion of existing problems of social and economical development, assessment of alternative options, evaluation of consequences of the their implementation with all stakeholders (citizens, public organizations, and businesses) and control on implementation by local government.

A necessary component of effective local economic development is strategic planning for the local territorial community that involves advisory structures such as commissions on strategic development. Many cities in modern Ukraine continue to plan their activity on the pattern of the Soviet centralized system, due to financial limitations, attachment, or insufficient knowledge.

In modern conditions, strategic plans for local economic development must be formulated with the participation of local authorities, nongovernmental organizations, the academic community, and businesses, with support from the local community. Significant obstacles to this innovation in Ukraine are an absent democratic tradition of public involvement and the lack of resources for involving public and for increasing public awareness.

Analysis of existing mechanisms of public involvement in decision-making in Ukraine suggests that there are two possible directions for this process: increasing public awareness about decisions of authorities and direct involvement of the public in the decision-making processes.

#### 4.1.1 Public Awareness and Access to Information

In Ukraine there are no legislatively fixed mechanisms and procedures of public and business access to information about the work of the government. Legislation on local self-government specifies no procedures for the publication of draft decisions, or for the publication of local councils and their executive committees' decisions, although people are provided with an opportunity to apply to local self-government bodies with requests for copies of adopted decisions.

The main sources of information on the work of local governments are the local newspapers founded by the local self-government bodies; coverage usually is limited to information about implemented measures, as opposed to preliminary information regarding planned programs and endeavors.

Today in Ukraine there is a real need for public awareness about the work of local governments, and there is a public call for access to information through modern means. The following practices of disseminating information about the work of the government among the public are the most widespread: web pages of local governments on the Internet, monthly ‘Open House’ days, telephone hotlines, and holding ‘Information Days.’ Publication of information brochures and bulletins containing basic indicators of the local draft budget; estimates of major projects and programs of local socioeconomic development; publication of materials about financial conditions and about housing enterprises; the organization of seminars and discussions with local government representatives to comment on problem issues

#### 4.1.2 Involvement of the Public in Decision-making

The law determines the main forms of direct public participation in decision-making as follows:

- participation in local referendums
- the right to elect and to be elected to local self-government bodies
- appeal to court on decisions, actions, or inaction of local self-government bodies and officials
- the right to submit written applications or personally call on local self-government bodies, officials, or clerks
- the right to get information about the local self-government bodies’ and officials’ activity, the right to peruse official materials and documents.

Another important form of direct public participation in local self-government is participation in local referendums on issues of local importance. Local referendums could become a mechanism of counteraction to local self-government bodies in cases when they ignore the interests of the local territorial community. Thus, it is possible to raise the issue of pre-term suspension of the local council responsibilities or its leader, and this provides a real mechanism of impact on elected bodies of local self-government in case of inappropriate performance. Unfortunately, Ukrainian experience shows a low level of patronage of the latter form of public participation caused primarily by the complicated procedure of referendum initialization based on proposals of the local community and, secondly, by scarce financial resources, that local self-government bodies are always lacking.

Important forms of public participation include the formation of expert committees and holding open public hearings, roundtable meetings, or focus group events on various important issues of local economic development, where members of the local community may raise questions of local interest to representatives of local governments and formulate their own options, the proposed options being mandatory for consideration by the government bodies.

Today it is possible to say that Ukraine has gained definite experience in facilitating and holding events of this kind. Unfortunately, the effectiveness of public consultations is decreased by the fact that neither government representatives nor community members have the skills to properly represent their point of view and provide convincing arguments. The lack of skills in constructive dialogue today results in the situation where public hearings risk turning into endless discussions or propaganda campaigns.

Advisory structures under self-government bodies have just started their establishment in Ukraine, particularly in *oblast* centers; the regulatory foundation for its activity is provided in the charters of territorial communities and special provisions approved by local self-government bodies. They envisage the formation of consulting councils, public committees, task forces, commissions, etc. The main aim of these advisory structures is to determine the needs of their local community and provide support for meeting these needs, performing as well supervisory functions for the implementation of programs initiated by self-government bodies and funded from local budgets.

Public control is performed through survey and monitoring of public service delivery, the work of public ombudspersons, and journalism. As a result of a survey on the quality of public services delivered to the population, "report cards" were introduced in the regions, that reflect the issues of gender segregation, education, public hotlines, and payment centers for housing services. Surveys on public attitudes about the implementation of this or that strategy by state authorities are also very useful.

## 4.2 Options for Increasing Efficiency of Local Economic Development

The weakness of the existing economic base for local self-government is due largely to insufficient regulation (primarily, at the legislative level) of:

- tax revenues of local budgets
- inter-budgetary relations
- exercise of ownership and property management by local governments
- state expenditures.

Local governments would do well to become much more involved in regional development. Directing the development vector is an important challenge for local self-government in Ukraine. But there must be a clear distinction between a region's economic growth and economic development. Growth can be extensive as well as intensive while economic development must occur on the basis of intensive growth. Development in Ukraine requires changing the relationship between people and the environment, changing institutions, and even changing criteria in order to see what is good and what is bad in the interaction of all components.

Local governments' limited ability to invest in construction may be improved by:

- increasing the share of local budgets' revenue allotted to investment programs
- expanding the practice of cooperation between the executive committees of local councils and local banks, businesses, and public in developing and implementing housing and industrial construction programs
- other types of loans (municipal borrowing).

A promising way of improving the financial condition of Ukraine's local self-governments, attracting investment and additional funds to deal with urgent problems of cities, districts, and other units is to issue municipal bonds.

Several factors favor the issue of municipal bonds in most of Ukraine's regions. The main factor is the lack of funds in regional budgets for investment programs and projects aimed at reviving communal lands and restoring buildings. Ukraine's municipal bond market, however, is still immature. Its formation is influenced by various factors, such as socio-economic characteristics, the lack of investment, and legislative restrictions.

Problems associated with issuing municipal bonds in Ukraine include:

- decreasing private investment as a result of rising loan interest rates, etc.
- imperfect legislation regulating the issue of municipal bonds as regional eurobonds and the issuing system
- unbalanced demand for and supply of municipal bonds, resulting from macro-economic problems as well as the conflict between the borrower's desire to reach its goals in a minimum amount of time and the desire of investors for guaranteed fast returns
- low concentration level of the municipal bond market, resulting in low placement figures for some issues
- lack of knowledge in issuing municipal bonds on the part of local self-government bodies.

Beside that, issuing municipal bonds, although prohibited, is still used by local governments in some form to solve their financial problems. Most often, however, such solutions take the form of mutual debt offsets which do not increase budget revenues.



Modern Ukraine's municipal bond market is in its infancy, with the number and size of municipal bonds issues made so far being very small and the terms of issue sometimes inconvenient. Credit resources extended to municipalities by Ukrainian and foreign banks are extremely limited, and issuing municipal notes is rare.

The creation of credit unions for regional development, or credit funds, is another way to promote the development of regional infrastructure. These institutions may be non-profit, and exempting them from local taxes and charges would enable them to provide credit at interest rates that are lower than elsewhere in the market, which would promote business activity.

The following initiatives may help improvement the regional investment climate as regards rebuilding:

- ensuring free exercise of land ownership by citizens, entities, and the state
- establishing reserve territories for the development of population centers.

The investment climate with regard to the management of land resources and renovation of territories in built-up areas can be boosted with the following initiatives:

- ensuring the unobstructed exercising of land ownership rights by the population and businesses
- formation of reserve territories for the development of built-up areas
- creating favorable conditions for attracting national and foreign investors in the areas of trade, hotel, transport, and other capital construction, in recreation activities, and restructuring ineffective production by renting land plots from state- and communal-ownership lands long-term, with the right of prolonging the terms of using the land plot or its buyout
- stimulating the development of the land market of cities and other built-up areas by providing investors with a broad spectrum of opportunities for purchasing state- and communal-owned land plots to engage in entrepreneurial activity.

### 4.3 Territorial Communities as a Subject of Local Development

Territorial communities should become a key subject of local development in Ukraine. The right of self-government of local communities, determined by Article 140 of the Constitution of Ukraine envisages independent resolution of issues of local importance under the framework of the Constitution and other regulatory acts of Ukraine. Despite the rather broad range of responsibilities delegated to local self-governmental bodies, especially those at the village, town, and *rayon* city levels, due to tough economic and budget limitations they actually cannot significantly influence the development of their own territories.

The main factor creating limitations to the leading role of local self-government bodies of villages, towns, and *rayon* cities in local territorial development is the absence of an appropriate economic base, which causes low budget revenues and, correspondingly, diminishes their opportunity to change the situation for the better. This creates a vicious circle: low levels of economic development—low output quality—poor competitiveness of output—low incomes of businesses and individuals—low budget revenues—no opportunities to improve the territory infrastructure—low investment attractiveness of the area—no investments—low level of economic development. Under current conditions, the absolute majority of local communities are unable to break down this vicious circle independently. Besides economic incapability, one more factor causing the weakness of local self-government bodies is absolute inability of employees to find solutions to the problems they face. The lack of skills to work in a constantly changing environment and under tough budget limitations, insufficient ability to cooperate with people in the course of conflict resolution and involve people outside their own communities from neighboring local self-government bodies are all shortcomings that only intensify the effect of the decline.

## 5. CONCLUSIONS AND RECOMMENDATIONS

The research undertaken enables us to formulate the following characteristic features of local economic development in Ukraine.

Democratic local economic development should be a major component of the overall economic development of the country but has in fact been among the weakest elements of Ukraine's economy since independence.

Development of ideas and instruments of local economical development takes place based on the use of two principle approaches: construction of an abstract scheme of territory development and using the unified norms of recourse distribution from the central level; and local development based on the available resources and taking into account the interests and initiatives of local communities.

Since independence, Ukraine has seen progress in local economic development, including the emergence of favorable conditions for local self-government performance, the emergence of both private and communal property, and the rise of the entrepreneurial class. Government bodies have to learn how to use new opportunities and resources effectively. Changes in the local economic situation should be assessed in comparison to their level in Soviet times, not compared to countries with longstanding traditions in sustainable development of self-governance and a market economy.

The legislative base for local economy formation in its basic aspects is formulated, but it has some contradictions which hinder effective implementation. Authorities of different levels and branches of local governments are not clearly demarcated and are

often duplicated. Fundamental issues such as what the responsibilities of local self-government bodies should constitute and what resources the execution of their authorities should be provided with have not yet been resolved.

Local governments do not have sufficient capacity to develop and implement strategic plans and local economic development programs. Municipalities lack the experience and skills to develop independent from the central government local economic policy aimed to solve local problems based on the local resources.

Local businesses play a more important role in local economic development. Business development gets complicated because of lack of skills and knowledge of entrepreneur activity, access to the information about the activity of local government and non-transparent procedures of regulation.

Level of investments engagement in the local economy is insufficient because of a lack of transparent and stable legislation, underdevelopment of local infrastructure, and over-regulation of business and economic activity.

Conditions of city infrastructure are unsatisfactory, and effective tools are lacking for infrastructure renewal and development, especially in housing and public utilities sectors.

The process of involving the public in local government decision-making has commenced. At the same time local governments do not have the democratic procedures and skills necessary to initiate and maintain dialogue with people; citizens are not aware of how they could control the public authorities' performance.

The research undertaken enables us to formulate the following recommendations on strengthening the role of local governments in local economic development:

On municipal policy development and implementation:

- Strengthen institutional capacity of local governments in economic policy development through trainings and development of standards and procedures of decision-making with participation of all stakeholders.
- Develop and approve strategic plans in the sphere of local economic development with the help and active participation of citizens and businessmen.
- Take into account the programs and initiatives of local economic development while the developing the local budget.

On local business development:

- Create conditions for registering business entities and licensing on the principle of “one-stop shopping” with consequent transfer to the electronic registration.
- Ensure public discussions and independent expert assessment of the drafts of the decisions to be taken by local governments; evaluate the efficiency of the decisions taken.
- Ensure free access to information regarding tenders arranged by local governments.

- Ensure development of local institutions for supporting business with the aim of free information circulation, providing consultations and trainings.
- Simplify procedures for leasing and selling land plots through reconsidering and eliminating the stages that are not expedient or are duplicated.
- Improve the mechanism of determining the size of rent and conducting payments for land plots; improve the methodology of determining the value of land plots to calculate the rent.

On direct investments attracting:

- Strengthen the capacity of local public officials in the sphere of investments through organizing training workshops and methodological support and cooperation with nongovernmental analytical centers and businesses.
- Ensure the development of specialized structures to deal with investment issues within local governing bodies or as independent institutions.
- Create local information resources regarding existent regional investment potential
- Ensure informational support for the investment process through improving the regional image on the internet and providing free access to information on regional investment potential and existent risks.
- Provide for post-investment support through considering the problematic issues at the joint sessions of investors, regulating authorities, and local governments.

On local infrastructure development:

- Increase the share of local budgets' revenue allotted to investment programs in local infrastructure renovation and reconstruction.
- Develop mechanisms of cooperation between the local governments, local banks, businesses, and public in developing and implementing housing and industrial construction programs.
- Create favorable conditions for attracting national and foreign investors in the areas of trade, hotel, transport, and other capital construction, external arrangement of territories, in recreation activities, and restructuring ineffective production by renting land plots from state- and communal-ownership lands for a long term, with the right of prolonging the terms of using the land plot or its buyout.
- Stimulate the development of the land market of cities and other built-up areas by providing investors with a broad spectrum of opportunities for purchasing state- and communal-owned land plots to engage in entrepreneurial activity.

- Single out attractive routes for privatization for urban and inter-city passenger transport and develop joint investment programs to build parking lots, service stations, etc.

On increasing transparency and openness of decision-making:

- Develop the mechanisms of public engagement in the decision-making process through public debates, public hearings, creation of advisory boards, public committees, and also creation of legal basis for their activity.
- Create a legal basis for the mechanisms of public and entrepreneurs' access information about the activity of local governments.
- Provide public expertise and public control on local government decisions implementation through conducting surveys on quality of public services, the ombudsmen's activity, and development of public journalism.

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## NOTES

- <sup>1</sup> As for today, Ukraine is a unitary state that comprises 27 *oblast* governments (regional-level bodies including 24 *oblasts*, the Autonomous Republic of Crimea, and the cities of Kiev and Sevastopol, which have *oblast* status), 490 *rayon* governments (county-level bodies), 451 municipal governments, and thousands of town and village government bodies.
- <sup>2</sup> Resolution 1801 of the Cabinet of Ministers December 28, 2001.
- <sup>3</sup> Presidential Decree 108/2001, February 22, 2001.
- <sup>4</sup> Special (free) economic zones are isolated parts of the country's territory that have special customs, tax, financial, organizational, and legal regulations for businesses.
- <sup>5</sup> Priority development territories are isolated parts of the country's territory that, as a rule, coincide with the existing borders of administrative-territorial units (*oblasts* or *rayons*), having special investment regulations in order to promote economic and social development.
- <sup>6</sup> Of all the taxes for which FEZs and PDTs have exemptions, only the land tax goes to local budgets.





# Urban Land Regulation and Local Economic Development in Russia and Ukraine: Evolving Systems and the Impacts of the Land Codes of 2001

## Overview

*William Valletta*  
*Natalia Korchakova*  
*Alexander Yanev*



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### INTRODUCTION

Systems of urban development regulation are among the important powers that municipal governments exercise in order to stimulate productive activity and capital investment while insuring growth consistent with social needs and environmental conditions. These systems encompass planning, land use regulation, construction permitting, and the allocation of government-owned resources while creating administrative and legal relationships between the government and private entities, landowners and land users, investors, developers, and builders. Depending on the way in which these relationships are structured, they may encourage and support productive investment or may discourage and impede such activity.

Recognizing this potential to help or hinder investment, the Russian Federation and Ukraine have undertaken the reform of urban development systems as part of their overall economic and legal transition. In recently adopted legislation, they have sought to define the framework for the legal and administrative relationships of government and private entities. In a number of local and regional initiatives, they have experimented with new regulatory and planning mechanisms. In general, the processes of reform have involved two approaches in the manner of linking government actions to private initiative:

- The municipality can create “partnerships” and organize direct relationships on a project-by-project or site-by-site basis.

- The municipality can adopt regulations or programs that apply to categories of projects, sites or to investors, landowners, or enterprises on the basis of their legal status, types of productive activity or geographical location. This second approach usually involves the system of regulatory “zoning,” in which uses and development parameters are defined uniformly for all land parcels in defined geographic zones of a city.

Examples of both approaches now exist among the cities of the Russian Federation and Ukraine; municipal officials and professionals are debating their respective advantages and problems. This paper compares the laws, regulations, and practice in representative cities in order to highlight the ways in which the reform elements in both approaches may affect investor security and lead to stronger or lesser levels of capital placement.

## 1. URBAN LAND USE AND DEVELOPMENT REGULATION IN THE CONTEXT OF A MIXED SYSTEM OF LAND AND PROPERTY RELATIONS

The reforms of urban development regulation are taking place in the context of transition, in which both the Russian Federation and Ukraine are seeking to establish socially-oriented market relations finding a balance between state management and civil law in economic life. The fundamental concepts appear in the Constitutions of both states, in clauses that combine the principles of civil contract law and property rights alongside declarations of social and environmental protection and the control of land and natural resources for the benefit of all citizens. In accordance with these balanced principles, the state and municipal governments retain ownership of large stocks of land, resources, and productive assets, which they can allocate and withdraw in order to generate revenue, support private investment and production and insure stability of supply and demand, thus moderating prices.

Two types of recently enacted laws have authorized the reforms in the systems of urban development. The land codes revised in 2001 in both the Russian federation and Ukraine define the powers of the state, municipal governments and private parties to own or use urban land in various categories and they organize the systems of land use regulation and management of state and municipal lands. Second, the laws on urban development create the processes of city planning and the procedures for the construction re-construction of buildings and infrastructure. The Russian Federation adopted the Urban Development Code in 1998 and Ukraine adopted its Law on Urban Development in 2000. Both laws retain the existing mechanism of site-specific planning and permitting discussed below as the “standard model of urban development”, and they also make reference to the mechanism of regulatory “zoning” as the methods by

which municipalities can control the permitted uses and parameters of development of land parcels.

In the land codes, three fundamental principles create the structure in which the powers of the state and municipalities and the rights and obligations of land owners, users, and investors, are defined:

- (1) All lands are to be classified in broad use categories—agriculture; urban housing and services; industry, transport, and communications; forest; etc.—and every parcel of land must be assigned a “designated use.” The use category determines the specific mix of elements of private and public law, defining the status of the individuals or entities authorized to acquire land of this type; the forms of tenure in which they may hold it; and certain restrictions on its possession, use, and disposition. The designated use specifies the activities development that can be established on the parcel.
- (2) Authorized persons may acquire and possess land in “ownership” or in subordinate forms of civil law tenure right of use, servitude, civil contract rights lease, pledge, and forms of administrative tenure retained from Soviet law—perpetual use, inheritable life possession, and limited term use.
- (3) Authorized persons can acquire rights to land in three ways: a) allocation of state/municipally owned parcels including vacant land for construction; b) transformation of their previously-granted administrative rights to the new rights of ownership or leasehold; and c) transfers of rights to land under buildings they have acquired in ownership. Land rights may be transferred and ended by the administrative process of “withdrawal” of rights by the state/municipality and confiscation of lands needed for public purposes. Civil law dispositions are mentioned but not defined in the land codes.

**Designated use** is the primary mechanism of municipal control over each land parcel and building site. It must be defined during the initial formation, and allocation of the land parcel and must be fixed, as a legal characteristic of the parcel, by notation in the cadastre and registry. Subsequently, it must be noted in all civil law transactions, contracts for sale, leases, and all administrative actions orders, permits, and registry changes. Any person making use of the land must adhere to the designated use. In order to change it, a procedure must take place in which the land parcel is withdrawn as a legal object, the land arrangement and urban development documents are revised, and the parcel is reformed, re-allocated, and re-registered with the new designated use.

The balance between municipal control of the land and that of the private parties in determining use and development depends on the process by which the designated use is determined and its resulting specificity. If the designated use is stated in broad categorical terms—i.e. “for trade and business service uses”—then the owner, user, or developer of the land can make a number of choices of uses in response to market opportunities and

production/trade technologies. If the designated use is narrowly defined—i.e. “for bank branch office”—then the landowner, user, or developer is limited to the initial choice. In the future, if change is necessary, he/she must forfeit the land rights and undergo a new allocation procedure. This can be time-consuming, costly, and risky since government agencies can intervene in the technical and economic considerations or change the terms and conditions of the land tenure.

In contrast to the designated use, regulatory “zoning” provides lists of permitted uses for the land parcels in each zone. The landowner, user, or investor can choose among these uses, with a simple administrative procedure in which the municipal planning office checks to insure that the proposed use is, in fact, on the list. A key question, therefore, under the new land codes and laws on urban development is whether a municipality can define designated uses in broad categorical terms or substitute the list of permitted uses by promulgating a zoning regulation. On this question, the Russian legislation appears to give municipalities a clear option, since both the Land Code and the Urban Development Code give express authority to municipalities to adopt zoning regulations. Ukrainian laws are less clear. While the Law on Urban Development of 2000 provides authority for municipal zoning, the Land Code of 2001 is silent.

On the question of **land ownership and subordinate rights**, the laws of the Russian Federation and Ukraine define the balance of state/municipal control and private initiative in different ways. The Russian Land Code states a general right of citizens and juridical persons to acquire land in ownership, except in categories of land retained from turnover. It authorizes any owner of land except noted categories to lease out land to domestic or foreign persons following the civil code requirements for the lease. These general provisions are subject to more detailed definitions of the persons and circumstances, applicable to specific categories and sub-categories of land. The Ukrainian Land Code does not declare general rights of ownership for citizens or juridical persons. It states that a domestic juridical person can acquire ownership of land “to conduct its entrepreneurial activities” when the civil law allows. This broad authority is subject to the definition of specific situations on a category-by-category, or sub-category basis.

In both Russia and Ukraine these provisions appear to offer the alternatives of ownership or leasehold for most land parcels, designated for urban industrial, trade and service uses. However, neither code provides authority for an enterprise itself to make the choice, based on its own needs or convenience. Either the codes mandate one form or the other, for the particular category or sub-category of use or for the type of enterprise acquiring it, or they leave the choice to the discretion of the state or municipal agencies. In practice, almost all urban, non-housing land is allocated in leasehold because city leaders believe that this gives them greater control—they can raise rents to capture land value gains and preserve for themselves a role in future deal-making.

The land codes and laws on urban development envision four scenarios for individuals, enterprises and other organizations on **acquiring rights to urban land**:

- (1) allocation of vacant parcels from the state/municipal stock for new construction
- (2) administrative grants transferring land simultaneously or subsequent to the sale or lease of buildings or structures standing on the land this includes land withdrawn from other users that is allocated for re-construction of the buildings on it
- (3) independent, civil law transfers of privately-owned parcels without change of use
- (4) applications to change the designated use.

Among these categories, some allocations and transactions must be done in conjunction with the procedures for forming the land parcel as a physical object fixing its location, size and boundaries and/or as a legal object setting its designated use, form of tenure and other conditions and limitations. The first scenario always requires both parcel formation processes. The fourth scenario always requires the process of re-forming the parcel as a legal object except in “zoning.” The third scenario never requires parcel formation. The second scenario requires parcel formation in two cases: the “privatization” of land already held by the building owner or the subdivision of a parcel with one or more buildings, which are being separated from a larger facility. Parcel formation is not required in the case when the building is already privately owned and stands on a previously-formed parcel held under lease from the state/municipality.

This confusing matrix of scenarios has the following practical meaning: an enterprise that needs land can wait until the municipality offers, by auction or tender, a parcel suitable for its needs. Or, it can apply to gain possession of the land on a temporary basis, carry out construction and gain the land leasehold. Then, in a second application, it can transform the leasehold to ownership if the city will agree to the sale. In practice, few cities in the Russian Federation conduct land auctions or tenders because they have a limited ability to realize financial gain. If the city initiates the formation of a land parcel it must bear all the costs of the technical work but can keep only 50 percent of the sale proceeds. The national and regional administrations claim the rest. Russian municipal officers, therefore, wait for applicants to request parcels and then, in the negotiations, minimize the land price while maximizing “in kind” requirements—infrastructure improvements, housing units, other tangible public improvements. In Ukraine, municipalities keep 90 percent of the price paid for land at auction or tender, therefore, some cities routinely hold land auctions.

## 2. The Process of Urban Development

When the elements of the land codes and urban development laws are combined in logical sequence, there emerges a standard procedural model approving development projects and forming and allocating land parcels. It represents a modification of the former structure of Soviet urban development. As reforms occur in different cities in Russia and Ukraine, their impacts can be measured by the ways in which certain stages of this procedure are eliminated or consolidated and certain administrative or legal relationships change. This study, therefore, describes the standard model and then compares several cities where reforms have been undertaken. The standard model consists of seven stages:

*Table 1.*  
Model of the Standard Urban Development Process

<p><b>1. Pre-project planning</b> State and municipal agencies prepare a hierarchy of plans:</p> <ul style="list-style-type: none"> <li>▪ spatial and socio-economic plans</li> <li>▪ general plan of the city</li> <li>▪ detailed plan of sub-city area territorial subdivision plan.</li> </ul>	<p><b>2. Evaluating investor intentions</b> A developer or investor proposes a new project or a city agency initiates a plan for a parcel or site. After agency review, if the project appears compatible with the plans and merits city participation, the developer is recognized as the applicant [<i>zayavchik</i>] and an order is given directing the technical departments to provide information and cooperate. The developer contracts for professional services to prepare the substantiating materials:</p> <ul style="list-style-type: none"> <li>▪ urban development documentation.</li> </ul>
<p><b>3. The permit to plan the land parcel</b> After review by pertinent agencies of the urban development documentation, the Land Department approves the documents identifying the land parcel to be allocated to the developer (if he/she does not already control it):</p> <ul style="list-style-type: none"> <li>▪ site location permit (contains size, location, designated use, and conditions for acquisition.)</li> </ul>	<p><b>4. The permit to plan the project</b> After review by pertinent agencies of the urban development documentation, the Architecture Department issues the order defining the permitted uses, parameters of development, and technical conditions for the project:</p> <ul style="list-style-type: none"> <li>▪ architecture-planning order [<i>zadanie</i>] —APZ.</li> </ul>



<p><b>5. Land parcel formation</b> Land professionals, surveyors, and landscape arrangers prepare the boundary line plans and gain agreement from adjoining landholders. The developer secures agreements from all existing tenants to relocate by providing alternative housing units, other premises, or by buy-out. The Land Department prepares the documentation:</p> <ul style="list-style-type: none"> <li>▪ land parcel plan</li> <li>▪ land legal documentation lease or purchase/sale agreement.</li> </ul>	<p><b>6. Project design review</b> The architects design the project, in accordance with the APZ. The plans are submitted to the Architecture Department, to all pertinent technical agencies, and to state expertise committees for building safety compliance. The Architecture Department prepares the documentation:</p> <ul style="list-style-type: none"> <li>▪ construction permit.</li> </ul>
<p><b>7. Construction</b> Developer registers the construction permit with the State Inspection Service and contracts for labor, construction management, and materials. Construction proceeds, with periodic inspections by the State Service.</p>	<p><b>8. Acceptance of buildings</b> Upon completion of construction a final inspection takes place and the State Service certifies completion in accordance with all laws and plans. The documentation is issued:</p> <ul style="list-style-type: none"> <li>▪ certificate of acceptance of the building for exploitation.</li> </ul> <p>The developer brings the certificate to the building registry Bureau of technical Inventory—BTI and is issued the registry certificate, which confirms the status of the building as an object of civil law real property rights:</p> <ul style="list-style-type: none"> <li>▪ building registration certificate.</li> </ul>
<p><b>9. Land parcel transfer and registration</b> On the basis of the building registration, the developer gains the right to take ownership or long-term control of the land. The Land Department prepares and the City Council or executive approves the land transfer:</p> <ul style="list-style-type: none"> <li>▪ Land lease or purchase/sale agreement.</li> </ul> <p>The developer brings the transfer documents to the Land Registry Office. Registration gives rise to the legal rights in the land.</p> <ul style="list-style-type: none"> <li>▪ Land registration certificate</li> </ul>	

The standard model of urban development anticipates that at all stages, until the end, the status of the project is defined in administrative terms only. This is a significant weakness that results in high risks. The developer must carry the entire cost of planning, permitting, design, and construction on the basis of unilateral permits and temporary rights to occupy land that can be revoked or refused extensions. The developer must undertake obligations with third parties—including labor contracts, materials contracts, project financing, and insurance. However, it can offer no security for these obligations

based on property or contract rights in the land and unfinished buildings. Construction mortgage financing is impossible. The developer also must secure removal and relocation of tenants on the land, without having property rights or “landlord” status. In order to achieve some level of security, the developer must rely on its business reputation and political connections, other assets he/she may hold apart from the project, state or city financial guarantees, or non-legal arrangements for protection.

The standard model invites abuse because the public officers and agency technicians play overlapping roles. As regulators, they have discretionary authority to approve the plans and technical documents, withhold approvals or order additional plans and documentation. They exercise the property rights of the municipality as a “partner” in the project and they retain direct regulatory linkage to the professional firms and “institutes,” which are paid by the developer to prepare the plans and documents. Thus, the officers and technicians are in a position to manipulate their roles in ways that can increase the developer’s costs and cause delays. To forestall impediments, developers will pay bribes or, more frequently, engage in side dealings with firms or associates, linked to the public officials and technicians.

### 3. COMPARISON OF SEVERAL REPRESENTATIVE CITIES

The reform agenda, in both the Russian Federation and Ukraine, intends to minimize these problems and risks. The following sections of this report describe the contrasting experience of representative cities, which have used the two approaches, described above—site-specific planning and permitting and regulatory zoning. These cities have drawn the attention of urban planning professionals in the Russian Federation and Ukraine and have made available a large amount information about their plans, policies and practices.

#### 3.1 Moscow

Moscow has focused on two parallel strategies of urban economic development, which apply in different districts. In the central “rings” there has been strong investor interest, but in the early years of economic transition the prime sites were subject to highly irregular speculative activity. The city administration has brought this situation under control by using a “partnership” mechanism in which the city retains a share of ownership in every project and receives substantial in kind payments for development permits—in the form of renovated apartments, parking garage spaces, and infrastructure improvements. In the outer districts with shabby housing and obsolete industrial facilities, mechanisms of subsidy “partnership” are applied. Here, the city-owned land, buildings, infrastruc-

ture, credits, and tax adjustments are contributed as incentives for developers. In both areas the basic concept is the same: the city takes the lead to identify sites, define their scenarios of development, and calculate the financial outcomes. Developers are sought and deals are shaped either through competition in the central districts or negotiation in the non-prime areas. Within this strategy of “partnership” Moscow has undertaken three major efforts of reform in the urban development process.

First, it has sought to streamline the procedures by eliminating overlapping tasks and decision-making among agencies and providing central coordination of project applications. This effort has led to the draft of a comprehensive urban development law, consolidating all of the standards and regulations previously adopted. The procedure combines the land and construction design permits, creating for each project a unified dossier of “permit-substantiation documentation.” The main permit thus becomes an “act of permitted use” which incorporates the designated use from land parcel formation, the permitted use from project design, and all servitudes and limiting conditions.

Second, within the general planning, Moscow uses the methodology of “functional zoning.” This technique consists of a three-level hierarchy in which broad use categories, more specific “groups”, and over 400 detailed “types” of uses are defined. Maps are drawn, showing 14 types of functional districts, nine types of construction districts with 42 development groups, and 12 types and 20 sub-types of landscape districts. When the maps are layered, they aggregate into 190 “micro-system” districts each with a particular mix of uses. The maps have legal status as “urban development documents,” which means that they must be followed or deviations justified in subsequent decisions on site location permits, land parcel formation, construction permits, and changes in designated permitted uses. Unlike regulatory zoning, the uses indicated by functional zoning are not legally guaranteed they are called “appropriate indicators.” The person who acquires land within a district does not gain a right protected by the courts to establish any of the uses within the categories, groups, or types. Instead, these definitions feed into the subsequent stages of project planning. Paradoxically, despite the extreme detail of the methodology, the experts, administrative agencies, and decision-makers retain full discretion, and the outcome of the process for any particular land parcel or project is always unpredictable.

Third, as the method of providing greater security and legal rights to developers, Moscow has replaced several of the unilateral permits with a contractual form. When the developer has presented the winning bid in the auction or tender or provided justification of its capabilities in negotiation, he/she gains the “right to conclude the investment contract.” This is a written, two-party document, in which the developer agrees to:

- pay for planning, design, and the costs of administrative review
- relocate residential tenants from the site and buy out non-housing tenants
- demolish or rebuild obsolete buildings and infrastructure
- install necessary new infrastructure and prepare the site for construction

- fulfill technical conditions of off-site engineering and social infrastructure
- construct the new or renovated buildings in accordance with the plans
- divide with the city the ownership of the newly built space.

The city administration promises to:

- transfer the land to the developer by short-term lease for the period of planning and construction
- transfer to the developer control over the buildings on the land in order to accomplish relocation and buy out of the tenants
- transfer into the ownership of the developer the agreed-upon share of the built space when the construction is completed
- transfer the land in a long term lease usually 49 years when the construction is completed
- refrain from granting conflicting rights to third parties in the land, buildings, premises, or other assets on the site
- assist the developer to gain necessary approvals, utility hook-ups, and replacement housing units for residential tenants.

The investment contract is intended to offer greater certainty for the developer, by spelling out the obligations, which he/she must undertake, and the terms of the final settlement of property rights and payments. This allows an accurate calculation of the project costs and resulting asset values and profits. Its contractual form should provide security because the developer can seek a court order, possible reimbursement of losses, or other remedies in the event that the city does not fulfill its obligations. There are, at present, many inherent limitations and unresolved issues concerning the status of the investment contract and the level of protection it affords to the developer. In particular, it does not transfer any property rights in the land or buildings until the very end, the major weakness in the standard model, as described above. Similarly, because the contract does not transfer property rights to the existing buildings, many questions remain about the status of the developer in relation to the tenants who must be removed.

Despite these shortcomings, however, the Moscow reforms of streamlining and the investment contract, have helped to normalize and clarify the administrative process.

### 3.2 Kiev

Kiev has followed the example of Moscow in trying to create “partnerships” and strengthen the traditional site-specific planning and regulatory system. However, Kiev’s strategy of “partnership” has been directed inward and its process preserves a Soviet style. The city has retained strong control over enterprises and assets in industry, trade, and

services, and its main economic development policy is to promote local products over “imports” and to subsidize and protect local firms rather than attract new investors. In this context, Kiev has undertaken few reforms, and its urban development procedures follow the standard model closely. Its system has been inefficient and subject to a high degree of administrative discretion, lack of accountability, and insider dealing. Recently, however, in line with the new land code, Kiev has initiated land auctions and transfers of land ownership to enterprises. These changes may signal a willingness to reconsider other aspects of development and regulatory policy.

Unlike Moscow, Kiev has not adopted consolidated regulations or integrated the land actions and project design/construction actions in a unified urban development review. There is weak administrative coordination and each applicant developer must take whatever actions he/she can in order to induce the various agencies to act in a timely manner and complete the substance of their work. The standards, embodied in the city regulations, reflect the concept that the developer’s project must accomplish a plan, which has been initiated and defined by the city in order to fulfill society’s needs. The developer’s own market-influenced purposes cannot control the planning choices and no effort is made to give them legal status. The key documents are issued as city administrative “orders” rather than “permits.” This means that the documents are written as if the city itself were contracting for and giving instructions to the architects, surveyors, landscapers, etc., with no recognition of the status or role of the applicant. This is very different from the Moscow “partnerships.”

In the initial stages of planning, Kiev does not use “functional zoning.” Instead, its local professionals have devised a related methodology of “economic-planning zoning,” which seeks to measure the “use value” of urban land through analysis of environmental and location characteristics, infrastructure service levels, and similar factors. By mapping areas where these factors are present in greater or lesser degree, and then layering the maps, numerous multi-factor zones emerge. Mathematical weights are applied to the factors in each zone to calculate relative values. The planners then refine the zone data to reflect conditions on a block or parcel and add demand-side factors needs for housing, industrial space, etc.. From this complex matrix they draw conclusions about the best permitted uses, development parameters, and infrastructure requirements for each block. When a project is proposed, the block level data is subdivided in mathematical proportions to the parcel level. Presumably, the municipal officers follow this body of analysis when making the decisions about project sites, land parcels, designated uses, and permitted development.

Kiev has made two significant changes in the standard model. First, in order to increase professional and public participation in planning and land use, the city has authorized the use of an architecture-urban development council. This is an advisory body of professionals, who can be named by the chief architect and empowered to review project plans after the technical agency reviews and before the chief architect and city

council approvals. Meetings of the council are open to the public and can be organized as public hearings. In substance, the architecture-urban development council reviews the project broadly rather than specific technical issues and it provides the important aspects of public education and participation. The council has been convened successfully for several recent private projects but, unfortunately, the city administration has not submitted its most prominent public projects to the council.

Second, since the effective onset of the new land code on January 1, 2002, Kiev has changed its policies on leasing and land ownership. Unlike Moscow, which has held quite rigidly to the policy of leasing land for industry, trade, and service uses, Kiev has experimented with land sales since 1999. These originally involved land parcels, already occupied by the enterprises, which sought ownership rights in negotiated deals. In August 2001, however, the Kiev City Council adopted new regulations on land auctions and tenders for development sites, covering both the sales of rights to lease and ownership rights. In 2002 and 2003, Kiev has increased negotiated sales and has carried out the first auctions of land ownership rights.

### 3.3 Regulatory Zoning Cities in Russia

Four cities in the Russian Federation have chosen the alternative of adopting local Regulations on Land Use and Development “zoning regulations.” The most complete reform of the urban development system has taken place in the following cities: Novgorod Veliki, Kazan, Samara, and Khabarovsk.

In terms of technical practice, the methodology of regulatory zoning is similar to “functional zoning.” Both divide the city into zones in which the groups or types of permitted uses and the scale and character of permitted construction are defined and mapped. But unlike “functional zoning,” which has multiple maps and always anticipates further detailing in parcel-specific plans, regulatory zoning results in a single map and text, which has legal status as normative standards and applies directly to land parcels and projects. This fundamental difference in legal status results in significant procedural and substantive changes from the standard model.

First, with regard to procedure, the stage of pre-project planning is eliminated and the process evaluating the investors’ intentions becomes one of checking the conceptual scheme or design plans against the pre-defined regulations to insure their conformity. This removes the discretionary “discovery” by the municipal officers of a single permitted use and set of development parameters, as the standard model envisions. In the land and project design review stages, there are more significant changes:

- The list of permitted uses for the zone becomes the “designated use” for each land parcel and the developer can choose among them.

- The development parameters are recognized as maximum or minimum standards. The developer can propose any number of building designs that “fit” within the parameters and can subsequently alter or expand the building, so long as this does not fall outside the parameters.
- Taken together, the permitted uses and parameters fix the primary conditions under which each parcel can be developed. This eliminates the need to justify the site location by an urban planning study and it eliminates the APZ.
- When a land parcel is being formed, its boundaries must be defined in a way that will allow many of the permitted uses and the maximum and minimum parameters, rather than one building design. This gives further flexibility for future changes.

In all the zoning cities, the system continues to be in a stage of transition, because the process of defining parameters for the many different uses involves lengthy and complex planning work. Thus, each of the cities has enacted regulations in which parameters are provided only for a few low-density residential zones, and gradually they are being amended to add standards and parameters for industrial, commercial, and other uses. During the transition it has been necessary to create a procedure and an administrative document for the site-specific definition of restrictions and conditions for the zones and uses where they are absent. The document is called the “land parcel use certificate.” It certifies that the proposed uses are on the list of permitted uses and that planning can begin subject to certain parameters and conditions. It is issued prior to the preparation of the parcel boundary plans and the construction design plans. It provides a legal definition of the development rights of the land parcel, in substitution for the administrative site location permit and APZ in the standard model.

With the certificate, the developer can acquire the land parcel in ownership or long-term lease as soon as its boundaries have been fixed in plan and on the ground. This can happen simultaneously with the issuance of the construction permit or even earlier. This eliminates the major item of risk in development—the weak rights of temporary occupancy during the period of construction—and it makes possible a mortgage of the land for construction financing. The certificate also allows the city, when it offers a land parcel in an auction or tender to directly sell ownership or lease the land as a fully formed object of the civil law ready for registration.

Furthermore, under zoning, the procedure of applying for project plan approval and the construction permit becomes separate from the formation of the land parcel. This is because the land rights are not linked to a single use and set of parameters. The process of reviewing the project plans involves only a “checking” to insure conformity with the regulations and other standards of construction safety, sanitation, environmental, or historic preservation. This also makes clear that the imposition of technical conditions



is an element of the land parcel formation rather than the construction design review. It means, in practice, that the costs of these conditions can be fully calculated and the agencies cannot re-open the negotiations in the project plan review.

In the zoning cities, the regulations provide for the creation of a commission for land use and development that can consider the application of the Regulations on Land Use and Development, both generally and with respect to certain specific projects. It can periodically assess the effectiveness of the regulations and propose amendments and it can hear appeals from developers, who argue that their plans have been improperly rejected. The commission can consider and grant “special permits” for uses—identified in the zone regulations—which require additional site specific review because of potential environmental, safety, or design concerns. The commission can also allow the “variance” of the use restrictions or parameters of development in problem cases. These procedures allow the developer additional mechanisms to assert its legal rights and insure that the guarantee of use and development of each land parcel is realized.

The adoption of zoning does not imply any particular policy with respect to the leasing or sale of ownership in land. In two of the four cities the regulations provide for auctions and tenders to be used in allocating municipal-owned land parcels without project plans. These provisions anticipate the sale of either ownership or lease. In practice, the four Russian zoning cities have continued to provide land for industrial, commercial, and service uses via long-term lease.

### 3.4 The Zoning Cities in Ukraine

In Ukraine, there has been a considerable body of technical and theoretical work and four cities have experimented with zoning. These efforts have not resulted in an effective practical system of zoning. Chernihiv was the first city to adopt local regulations on land use and development in 1995, and Poltava subsequently drafted, but did not adopt, these regulations. Odessa adopted regulations for a single zone, and the small city of Khahovka enacted a simple zoning plan. These regulations define permitted land uses and fix some parameters on a zone basis; however by legal status they are urban development documents, not regulatory norms. This means that the regulations preserve the stages of pre-project planning, parcel formation, and project design review of the standard development model, and they retain the site location permit and APZ. Thus, the relationships between the city and developer continue to take the form of unilateral, administrative permits, not legally guaranteed in land or project applications.

In a methodological “Guidebook on Zoning,” published by Ukraine State Committee on Construction and Architecture further changes are anticipated, including the replacement of the APZ by a document of preliminary approval called “conditions for building over and using the land parcel.” These “conditions” would be issued to the



applicant in the form a permit, not in the form of an “order” to the architects and other professionals. Thus they would establish a direct administrative relationship and allow the developer to control the technical processes of design. The guidebook clearly asserts that “the conditions for building over and using the land parcel” do not create a right of ownership or use of the land parcel or create rights “in any party.” Nevertheless, if the developer disagrees with the conditions, he/she can appeal to the courts and if, during a two-year period after the conditions are issued, the municipal legislative council changes the conditions for development, the developer can claim compensation. On the basis of this description, the “conditions for building over and using a land parcel” would offer a partially enhanced legal status to the developer. It is not a status that rises to the level of an investment contract with court protection between the two parties or a property right with court protection against all third parties, but it would provide some additional security.

It must be noted that, up to the present, no municipality in Ukraine has adopted regulations, which embody the ideas expressed in the guidebook. A particular setback for zoning has been the lack of any mention of the mechanism in the land code of 2001. Thus, most municipal officers and professionals believe that they must adhere to the traditional methods of determining the use and parameters of development for land parcels—that is, by urban development documentation and the processes of hierarchical spatial planning and land arrangement. Similarly, since the regulations in Chernihiv, Poltava, and Odessa were written before 2001, they have no clear link to the provisions of the land code regarding auctions, tenders, and other provisions on the formation of land parcels and defining land rights.

### 3.5 Reform Activities in Other Cities

Throughout the Russian Federation and Ukraine, the great majority of municipalities are following the lead of the capital cities, retaining site-specific administration of urban development with adjustments intended to streamline the process. In Russian cities, there is increasing use of the investment contract and a strengthening of the policies of “partnership.” In Ukraine there is emphasis on the pre-planning of sites by city agencies and the use of auctions and tenders, in accordance with the new land code.

Among Russian cities, the investment contract takes a variety of forms. Some city and regional administrations use it for housing development and redevelopment (Cheboksary) while others apply it to industrial and business service projects (Kaliningrad). In some cities the contract applies primarily to the aspects of building and infrastructure construction, while in other places it encompasses investments in equipment renovation and the modernization of labor skills and production processes. In at least one city (Rostov-na-Dony) the investment contract secures environmental improvements from

the investors/developers. In all of the variations the underlying structure of partnership remains—that is, the city establishes a relationship with the private investor that combines a contractual agreement with administrative permits. Transfers of land and real property rights come at the end when full investment and construction has taken place. Transfers of movable property rights, shares of the enterprise, and ownership of equipment or inventory are subject to negotiation and, in most cases, do not give the investor majority or independent control. The programs all reflect the underlying idea that the city has taken the initiative to identify an economic and socially favorable investment and that the investor or developer accepts the obligations to fulfill the city's plan.

In Ukraine, the smaller cities have followed the lead of Kiev, making changes in the structure and process of urban development without incorporating the formalities and legal status of an investment contract. The reform efforts emphasize procedural coordination, the pre-planning of sites, and their offer by auction and tender. In some cities, changes have been made in the structure and authorities of the municipal agencies, to clarify control and accountability for timely consideration of applications (Lviv). Some cities have consolidated their regulations to better integrate the processes of land parcel formation and allocation with the processes of building design and construction permitting (Dnipropetrovsk). Dnipropetrovsk has also introduced an "Agreement Reserving the Land Parcel," a contract that is signed by the mayor and developer after receiving approval from the city council. The city agrees to set aside the particular land plot exclusively for the developer and not to take any contrary actions during the term of up to one year of project planning and land parcel formation. This agreement is not a full investment contract but it does offer the developer a more secure position than with an administrative site location permit.

In order to prepare sites for auctions and tenders, many cities create an annual list of land parcels and charge the technical agencies with the tasks of pre-planning. The designated and permitted uses, parameters of development, technical conditions, and preliminary parcel boundaries and characteristics are defined, and the agencies sign-off on a preliminary scheme for development of the site. This allows the "right to lease" or the "right to develop" the land parcel to be sold along with a "package" of the substantiating documents and planning permits site location and APZ. This process preserves, in formal terms, all stages of the standard model but allows the developer to buy into the process at an intermediary point, sparing him/her the uncertainties but reimbursing the costs of the earlier planning stages. Of course, this method works efficiently only to the extent that the developer's ideas correspond closely to the scheme anticipated by the city agencies. If substantial changes in the "package" are necessary for the developer to realize the project, then the substantive and legal aspects of the project must be reopened, subject to full agency discretion in the negotiations.

## 4. CONCLUSIONS AND RECOMMENDATIONS

The effects of the reforms introduced into the urban development process should be reflected in comparative data on capital investment and building construction in the various cities. One would expect to see a difference between those cities that provide greater security to developers and those that retain a high level of bureaucratic discretion and administrative, rather than contractual and property, relations. At present, given the short time period and the limited amount of data collected and reported on Russian and Ukrainian cities such an analysis can be done only in a preliminary way. For this report, a rough method of statistical analysis is presented to provide a framework for monitoring the effects of reforms over time. The model compares regional data on capital investment, investment in housing construction and reconstruction, and capital investments made from state and municipal budgets, supplemented by local data published sporadically by the cities.

From the limited data, a few conclusions are drawn. Moscow and Kiev show the highest levels of overall capital investment, investment in non-housing assets, and building construction. This is not surprising given the tendency of centralization in basic industry and main sectors of trade and services. When these two cities are compared, however, strong differences are seen. Although Moscow, by population, is three times the size of Kiev, it appears to be attracting 30 times the amount of non-housing domestic investment and 10 times the amount of foreign investment. Much of this difference is the result of the geopolitical importance of Moscow and its control of the enormous mineral and energy wealth of the Russian Federation. Some of Kiev's weaknesses may also be attributed to its less efficient urban development system although this is not proven by the data.

Outside the capital cities, there are no clear indicators of the progress of urban development reforms. The most that is revealed are differences attributable to the dominant industries of each area and its broad regional or local economic policies. In the Russian Federation, the local figures show a great variety of investment levels, as one would expect, given the size and diversity of economic resources and conditions in urban regions. The four "zoning cities" have achieved relatively high levels of capital investment compared to other places of similar size and mix of economic sectors. However, other "non-zoning cities" are achieving similar relative high levels—thus, one cannot isolate the reform programs as the decisive factor. Generally, the best performing cities in the Russian Federation fall into the one million or more population category and are centers of oil and energy production or energy-related equipment manufacture and services. Some cities and regions, however, may be prospering because of their "pro-business" and "pro-investment" policies. In both the statistical data and the economic development literature, the "pioneer" reform city and region of Novgorod stands out. Novgorod was

the first city of the Russian Federation to adopt zoning in 1996 along with other reforms in city and regional laws. From 1996 until 2000, the city has attracted over \$130 million in direct foreign investment and a similar amount in domestic investment. The Novgorod region has attracted almost \$500 million in foreign investment and a similar amount of domestic investment. Most significantly, for both the city and region, a high proportion of the domestic investment has been private rather than state or municipal. Although the statistical correlation cannot yet be shown between its reform efforts and its investment performance, reports and studies based on interviews of business participants and public polls indicate that many people have made the connection.

In Ukraine, the data on capital investments and construction show poor levels everywhere, with relative strength only in a few industrial regions, where the economic base revolves around energy, metal, aircraft, and military production. In these industries, state funds make up a high proportion of the investment capital. In all regions, the data show weak levels of private capital investment and very low foreign direct investment. The city with the most “pro-business” reputation, Lviv, shows only slightly higher levels from the national averages, providing no indication that the city’s efforts in streamlining its urban development procedures without providing stronger property or contract rights for developers make it more attractive for investors.

The report reaches the overall conclusion that, without reforms of the urban development process, investors in the Russian Federation and Ukraine will continue to face a high level of risks and costs, without a balancing legal security. The land codes of 2001 have made some progress in allowing reforms, by adding elements of civil property law and market-economic mechanisms to land development relations. The introduction of legislative authority for regulatory zoning has also provided the framework for cities to make significant reforms. In both countries, the laws still lack a fundamental principle—that is, while the civil law forms of property rights ownership, lease, and rights of use now apply to urban land, the urban development process can continue to ignore these rights as the basis of development. This is contrary to modern practice around the world, where rights in land and buildings provide the foundation for development financing and provide security to other contractual relations, which the developer has with third parties. In the sphere of urban development in the Russian Federation and in Ukraine, the rights of ownership and long-term lease are viewed as a “reward” that is given to a developer who has first proven his/her worthiness by completing all the socially valuable aspects of project development. Further reform, therefore, is necessary to make a deeper substantive change in the urban development process. The following strategy is recommended for all cities:

1. Formulate a multi-year program of reform of the urban investment process, to consist of several stages of short-term and long-term reforms.
2. Adopt temporary regulations that include the following elements:

- Clarify that “designated uses” and “permitted uses” of land will be made in broad categorical terms, rather than narrow, single project terms. Future changes will be allowed among uses in the category, with a simple “checking” procedure and without withdrawal of the land parcel.
  - Adopt a standard form of “investment contract” in which the mutual obligations of the city agencies and the developer will be defined.
3. Initiate a program of drafting regulations for land use and development that will set up a system of zoning. The first draft regulations would provide the definitions of permitted uses and parameters of development for the zones of routine and small-scale housing, trade and services, and light industrial production and transport.
  4. Revise the municipal regulations on the pre-planning of sites and their offer by auction and tender. These should provide an open process in which all pertinent agencies participate and all records and transactions are subject to public scrutiny and audit.
  5. Incorporate new elements of analysis into the city general plan that consider the economic conditions of the city in terms of its competitiveness in a dynamic, modern economy. Market-related data about land and real property prices, available financing, and the costs and burdens of risk should become part of the consideration of the city’s economic and social situation.



# The Changing State of Local Government

*Soňa Čapková*





# The Changing State of Local Government

## *Summary and Conclusion*

*Soňa Čapková*

Local authorities in Central and Eastern Europe have been confronting a complex web of social and economic issues over the last fifteen years. Economic transformation, globalization, growing unemployment, and high disparities between rich and poor define a situation requiring articulated solutions. Local governments are pressed both to meet social obligations to citizens and to stipulate development strategies. In many fields there is a quest for new approaches to local policy.

This chapter draws on research included in the country reports and summarized in the previous chapters. These reports highlight the importance of the changing economic and political conditions within which local governments are undertaking local economic development activities. Our contention is that local governments pursue local economic development activities in response to these changes. Economic development had not been a function of subnational authorities under the previous regimes. Such activity has occurred only recently within the last decade. The slow growth of national economies in the early nineteen nineties has resulted in slow growth or even decline in many local economies. Economic restructuring has caused particularly hard economic times for localities dependent on declining industries, and reduced national assistance for local economies have thrown local governments back on their own powers to cope with new situation. Among both national and local policymakers there is increasing recognition that local communities must use their current human, social, institutional, and physical resources to build a self-sustaining economic system. It has been gradually accepted that economic development initiatives are an important component of local public policy.

### 1. THE POLITICAL-ADMINISTRATIVE BACKGROUND

Recent trends in Central and Eastern European economies have shifted responsibility to local governments and in many cases reduced government regulation in favor of presumed market efficiencies.

Three major policy changes and public sector reforms come to bear on local government and local economic development: regulatory reform, privatization policy, and decentralization policy. The reform of government regulations has focused on removing barriers hampering competition, entrepreneurship, productivity, etc. A part of this reform is deregulation, i.e. a partial or complete elimination of regulation to improve economic performance. Extensive privatization of state-owned assets as a part of economic liberalization measures and public sector reform policy has been aimed at improving the operation of government-owned enterprises and reducing the role of government in the market economy.

In the past decades the decentralization processes have grown substantially in all countries. The general motivation is for decentralization to make policy more responsive to local needs and involve local populations in the processes of democratic governance. It is broadly recognized that the advantages of decentralization include emphasizing administrative responsiveness, increasing political participation, and promoting democratic principles.

The impact of decentralization and other changes in government policy have resulted in an increasing role for local government in promoting economic development programs and activities. As government at all levels has become more fragmented and dominated by market forces, greater responsibility has been placed on local governments. Most local politicians agree that participation in a wide range of economic development programs has become increasingly necessary (although not always sufficient) to promote local economic growth.

The potential of local authorities to undertake local economic development depends on a number of factors and processes. The degrees of local financial autonomy and administrative capacity are perhaps most important among them. Decentralized finance appears to play a role in economic development. Local accountability calls not only for decentralized decision-making but involves financial competencies together with the right to borrow.

## 1.1 The Fiscal Dimension

There is no formalized theory of the relationship between fiscal decentralization and economic growth. Oates (1993) points out that there are strong reasons to believe that policies formulated for the provision of infrastructure and even human capital that are sensitive to regional and local conditions are likely to be more effective in encouraging economic development than centrally determined policies that ignore these geographical differences. Within this context it could be argued that fiscal decentralization allows more effective implementation of economic development projects. In particular, public utilities such as roads, sewers, and water are a means to economic development. Essen-

tial to the development of real local autonomy is the right to raise own revenues. Local authorities need independent sources of revenue

Sometimes, public responsibilities have been transferred to local governments without adequate transfer of sources. During decentralization, local officials have been given much more authority to deal with local problems. However, there are more problems than money. On the one hand, local governments have expanded their efforts in economic development to deal with social problems and new challenges. On the other hand, they have experienced continuing fiscal difficulties such as in raising adequate revenue and increasing demand for funding public services because of cutbacks in state funding. The restricted financial capacity and autonomy of the local level (as in Ukraine, Bulgaria, and Russia) is combined with comparatively limited local involvement in economic development activities.

Local authorities need their own independent sources of revenue. The structure of local taxes makes it more or less impossible for local authorities to raise sizeable revenues from taxation in some countries. Local tax revenue and tax transfers from state to local governments were important in all reviewed countries. Taxing powers (the discretion in deciding local tax rates) are inevitable in the use of tax incentives in order to promote the local economy. There are a variety of local taxes where local authorities have real fiscal discretion (primarily property tax) but the majority of these taxes do not constitute a major burden to businesses. For many businesses, local taxes are a small proportion of total business costs. It is not clear that tax abatement is economically sound. More importantly, it is doubtful whether the granting of tax abatement affects firms' location decisions.

## 1.2 Capacity Concerns

There are certain conditions that must be satisfied if local government is to have capacity to undertake economic development activities. The capacity of local government depends on many factors, such as the quality and quantity of local officials, the knowledge and data required for effective policymaking, access to technology, and available revenue.

Local government leadership (political and administrative) is fundamental to the creation of a supportive business environment. The development of qualified economic development professionals is often the core of successful local economic development.

Capacity problems result not just from the lack of resources and information at the local level, but also from lack of administrative and policymaking skills as well as deficient training in local economic development.

The availability of trained local personnel is a precondition for more efficient activities. Unfortunately, local governments (especially in small municipalities) lack trained

personnel. Even if such personnel reside within the locality, competition from private sector for skilled personnel is intense. Cities are more likely to hire professional managers and employ more experienced staff. Local government capacity and policy decisions are associated more with socio-economic factors such as education level, poverty, and economic base than with geographic location.

## 2. MAJOR POLICY AREAS AND ISSUES

Currently, local governments in Central and Eastern European countries began to promote local economic development due to the decline of traditional heavy industry. In the late 1990s unemployment rose, thus further catalyzing development efforts.

It is difficult for local government to fulfill an ascribed role in economic development if the responsibilities for these activities lie with other layers of government. Logically, local government efforts have concentrated on the factors directly under their control. That is why local economic development initiatives in surveyed countries involve a variety of instruments and assessing their implication is highly difficult.

### 2.1 Location Incentives

Improvements in infrastructure are critical to economic development. The lack of basic facilities is an obstacle to the increasing productivity of local businesses and attracting inward investment.

Special significance is given to local capital investments in all countries. Infrastructure needs are high and their financing in part has fallen to local governments. Many local governments are making great efforts to carry out capital improvements. Depending on legislation, local governments concentrate on improving and extending municipally controlled infrastructure (water, sewage, heat supply, garbage collection, public transportation, etc.).

Other services not previously regarded as infrastructure are now seen as important for economic development. Such services include education facilities capable of delivering appropriate training, health care, recreational, and cultural facilities.

Municipalities have had to become more active in their efforts to influence the development of infrastructure not directly under their control but which is of great importance to the area's business environment (e.g., telecommunications, highways).

Supply-side efforts to improve the quality of the labor force and the level of quality of public infrastructure are predicted to have strong long-term effects. Despite the limitation to such traditional economic development strategies, many municipalities invest in industrial parks and other infrastructure, develop an inventory of sites and buildings

suitable for development in the hope of luring a firm to their community. A number of more specific policy measures such as enterprise zones are also common in some cases (although in the case of Ukraine the free economic zones and priority development territories are not local but regional and central government initiatives).

According to the country studies, local governments are placing much emphasis on attracting businesses from outside. Even where there are no grounds to confirm their effectiveness, many programs to attract business are being implemented. Many local officials believe that their municipalities must offer incentives to compete with those offered elsewhere. More and more local governments offer industrial location incentives to help top businesses' location decisions in their favor. The use of location incentives in many cases reflects the desire of public officials to credit themselves with the location of large, highly visible plants.

Activities designed to attract investment have their background in rapidly increased flows of foreign investors in Central and Eastern Europe in the 1990s. Accession to the European Union, accelerating the convergence of legal and regulatory environment to Western European countries, has played an important role in strengthening the framework for foreign investment in pre-accession countries. Though the domestic market is rather limited, they attract large amount of foreign investors due to production cost advantages. Russia and Ukraine, with their large markets and extensive natural resources, have significant potential for securing foreign investment.

## 2.2 Emphasis on Attracting Foreign Investment

It is widely believed that the attraction of external businesses will create jobs and reduce unemployment. The attraction of inward investment (primarily foreign direct investment) has been stimulated above all at the national level through subsidies and economic aid, location incentives, and public investment in infrastructures. Industrial location incentives are also being offered by local governments to influence a firm's location decision. These incentives include financial (including tax concessions), labor-related, or land-use incentives.

Large, modern businesses tend to be seen as catalysts for local economic development. Inward investment tends to aid the start-up and development of local firms as a by-product of relations with local suppliers. Attracting foreign investment is often seen as a great success even if some municipalities have experienced the effects of downsizing or closing local branches of foreign-owned operations because of financial pressure.

Foreign direct investment, however, is not a panacea. Moreover, only certain territories have the specific resources and assets to attract inward investment. The municipalities and regions in industrial decline or suffering environmental degradation are usually unattractive for innovative firms. There are dangers in relying too heavily on foreign

investment. In cases where employment opportunities have been reduced and there is no technological basis to move into higher value sectors (as is the case in many Central and Eastern European regions), the temptation is to attract foreign investments through low-wage and low-technology assembly plants. Evidence shows that such plants tend to have lower numbers of highly trained and skilled employees and devote little attention to non-routing activities or new products (Malecki 1994: 126).

In brief, local economic development activities as they are currently undertaken predominantly attempt to attract economic activity and jobs to the region or locality from outside.

## 2.3 Local Business Development

Yet, in aggregate terms, it should be small and medium-sized firms that are most adequate for job creation. A large number of jobs are created by small businesses, and “home-grown” businesses tend to be more loyal to the community (Winders 1997). Therefore investment in these approaches may have a more lasting effect on local economic development.

Having recognized this, local governments have widened their activities on creating the basic infrastructure needed by local businesses. Some municipalities provide firms with industrial sites and premises to be leased or bought at reduced prices.

Municipalities in all countries have gradually started to implement development projects focusing on such issues as the expansion of existing businesses and the start-up of new business. In addition to the recognition that small and medium-size enterprises can play in the local economy and job creation, some local authorities have begun to adopt demand-side strategies to foster local enterprise development. With the help of national and international funds, local governments have started to provide technical assistance, loans, loan guarantees, interest rate subsidies, low-cost premises, and public procurement preferences. Small business incubators, both high-tech and low-tech, have become a popular way for local authorities to foster business development through the provision of facilities, technology transfer assistance, management training, and marketing assistance. Common strategies also include establishment of entrepreneurship centers providing business with advice and technical assistance such as business information, counseling, and training seminars that help potential entrepreneurs and small businesses to develop better business plans and locate financing, revolving loan funds, business management assistance, and other services aimed at responding to local business needs and strengthening the entrepreneurial base of a municipality. Such services are usually focused on small and medium-sized businesses.

The number and growth of programs supporting entrepreneurship and micro-enterprise is not negligible. Much of the policy encouraging entrepreneurship reflects

the belief that the creation of new firms will achieve economic and social objectives. Increasing rates of enterprise creation is an almost universal concern for central governments and for local authorities wishing to combat economic distress.

However, despite the extent activities, few studies have systematically examined the relationship between the birth of new firms and local economic development.

## 2.4 The Local Business Climate

Local governments in all reviewed countries are responsible for local physical infrastructure and other components of the local business climate. Unsurprisingly, local government actions are predominantly designed to improve the “hardware” of local economic development and wishes to equip localities with necessary transport and communication infrastructure. Next, training initiatives aspire to endowing local economies with the qualified human resources that will produce competitive goods and services. Local government initiatives reach further and try to improve the “software” of economic development to promote start-up and development of existing local firms, thereby creating and spreading innovation. Information and marketing initiatives try to improve the local entrepreneurial climate.

However, one of the most effective local economic development activities that municipalities can undertake is to improve the process and procedures businesses are subjected to by the local authority itself. Reducing friction and communication problems between business and local government is fundamental. Local governments must have a basic idea of business principles and a non-paternalist view of local business. Research in surveyed countries reveals a number of complex, poorly-managed, expensive, and unnecessary business registration, permission or licensing systems, and extensive and slow administrative procedures often connected with corruption. By improving and reducing these, local governments can quickly improve business climate.

There is no doubt that local government should exert some degree of control over land use and development but not discourage the private sector from investment. In some cases the problem lies in over-regulation and in the large number of participatory agencies deriving legal authority from separate sources which results in fragmentation of administration procedures. Excessive land use regulation, titling requirements, and subdivision approval requirements present costly bottlenecks in acquiring and developing land in Russia and Ukraine. Moreover, lack of secure tenure during planning, design, and construction mean high risks for investors.

Local government may develop a business-friendly disposition and remove government-induced obstacles, particularly in terms of clumsy and complicated licensing and permit processes. Some examples mentioned in country studies include the creation of first-stop or one-stop agencies, establishing streamlined administrative procedure, provi-

sion of efficient real estate information systems, location marketing efforts, and efforts to make local regulation more transparent, easy to handle, etc. The use of information technologies is helping in this.

Local government sets the tone for development by making it either easier or more difficult to do business. When time-consuming processes and costly and onerous permitting and development regulations are avoided, the “local business milieu” is enhanced considerably.

## 2.5 Strategic Planning

A local economic development plan defines goals and priorities, providing the necessary framework for local economic development. The emphasis on regional planning in all states generated a wave of strategic development plans both at municipal and regional levels. Most local governments formulate a development strategy – a critical component of the municipal planning process. However, formal economic development plans are rarely prepared. Activities focused on strengthening the local economy form a component of a broader strategic plan for development.

In former communist countries, the focus of planning has altered from top-down, central government-driven planning to more locally based and participatory approaches.

Local development plans are based on a territorial approach to development. The method of developing SWOT analysis to outline vision, goals, and objectives, and identify strategies and actions for socio-economic development programs has been used by many local governments (as illustrated in the case of Lithuanian municipalities). As local governments lack adequately skilled personnel, strategy documents are often prepared by contracted consultants or academic groups with different amounts of citizen (and local authority) participation. The time horizon for a local development strategy is typically five to ten years with associated short- and medium-term deliverables.

Development strategy documents are frequently intended to justify financial support from the European Union or other external sources that strongly emphasize programming. The European Commission has invited local authorities in pre-accession countries to work together on a regional basis to prepare development strategies which would provide the context for the allocation of pre-accession and structural funds. These strategies usually give a direction and focus for local economic development activities. Anyway, the main role of such strategies is often to produce a document that ensures the municipality is able to bid for funds. Thus the existence of a plan may be more important than its content.

Nevertheless, strategic planning involves more than merely elaborating a document. A strategic plan is of little use if the municipality or region does not have the capacity



to implement it. Local government must be especially effective in its ability to carry out economic development projects. A framework of strategic planning which integrates all the aspects of community development helps policymakers take a more comprehensive look at their local economic development policies and is more likely to achieve efficiency in resource allocation and political accountability.

With respect to a planning framework it should be pointed out that some local governments try to approach economic development in a strategic manner, while local economic development activities are often limited to particular projects that should contribute to development of local economy, but it is not a part of any overall strategy or plan. Local authority initiatives aimed at economic development are inadequately coordinated. Adequate coordination does not occur with other local authorities and/or with the initiatives of other agencies. Most local economic development initiatives have been undertaken in a fragmented way and suffered as a result of inadequate funding and operational inconsistency.

Meanwhile institutional support for economic development at the local level has become more complex. A set of institutions that provide the structures within which economic development operates has been established. Agencies involved in economic development activities attempt to develop new roles and programs; however, they need to consolidate their own position in relation to other players.

A strategic approach and solutions tailored to local conditions are essential to a successful local development policy. Local economic development should not be seen as a group of various initiatives operating at the local level. Rather, it is a means of integrating different policies and programs at the local level and improving local governance through involving the public in the formulation and implementation of policy. Moreover, local development planning leads to the greater involvement of all local actors.

A strategic development plan provides space for coordinating local policies with economic and social development measures as well as adapting national and regional policies to local conditions. For an efficient policy a synergy between local government initiatives and the actions of the rest of the administration that promote structural changes should be produced. It is essential to ensure that local policies are consistent with national and EU policies. Local initiatives have to be articulated with sectoral and regional policies of the remaining administration and organizations.

## 2.6 Partnership

Local governments are increasingly acknowledging that they do not have sufficient resources, skills, or organizational foundations to meet the needs of local economic development in their areas. It has been commonly recognized that local governments cannot succeed in promoting economic development if they attempt to act alone and

local economic development strategies cannot be implemented without close collaboration with other actors. But local governments can play a catalytic role in an economic development partnership because they are in a unique position to bring all stakeholders together, mobilizing local resources to support economic development. Multi-sectoral collaboration implies participation from the governmental, private, and non-profit sectors.

Partnerships are becoming a popular tool to improve local governance. They have been set up in all surveyed countries to tackle the issues of economic development, employment, and social cohesion. Local partnerships are established across levels and between public, private, and nongovernmental sectors. New forms of governance are currently in experimental stages.

Most partnerships are area-based—government services, local authorities, employers, trade unions, and community organizations in a given area work together to design strategies, adapt policies to local conditions, and take initiatives consistent with shared priorities. The skills, experiences, and resources that each stakeholder brings to these processes make up the critical foundation of local development capacity. Establishing working relationships and structures, and developing a shared view of objectives, leads to improved local coordination and implementation.

The degree of partnership ranges from permanent coalitions to special purpose arrangements for specific projects. During the first half of the 1990s, partnerships were mainly the results of isolated local initiatives. Increasingly, partnerships are a response to a central government (or European Union) edict or incentive.

However, working in partnership is not easy. At the heart of all effective partnerships are interpersonal relationships. The close interaction of different bodies may be a source of tension, especially at the beginning, which reflects partners' contrasting organizational forms, different responsibilities and priorities, and administrative and geographical environments. Perceived power imbalances, which often occur, for example, between a large local authority and a small nongovernmental organization, make some partners feel vulnerable and can lead to difficulties. The establishment of an environment that utilizes the capacity and competence of each partner helps strengthen partnership. Differences in working practices, professional languages, and organizational cultures contribute to slower progress and outputs than what is usually expected. In any case, mutual understanding is the precondition for cooperation in partnership and sufficient time is required for discussions and debates in order to achieve consensus and establish ownership of the agreed policies.

Market-oriented changes in Central and Eastern European states have meant greater involvement by nongovernmental organizations in the delivery of public services. With regard to economic development, they provide job-related training activities and develop micro-finance schemes to promote economic development.

However, many of these organizations experience problems such as lack of managerial skills, uncertain financing, fragmentation, poor coordination, and at times lack of transparency and accountability. These problems can be overcome by forming partnerships between local governments, nongovernmental organizations, and private organizations, as well as investing in capacity- and institution-building.

## 2.7 Rural Localities

In the face of changing intergovernmental relations local governments are taking on increasing responsibility for local economic development. But the initiatives are very often limited to urban areas. This also reflects the research presented in country reports which have been focused mainly on the activities of urban municipalities. Local economic development is usually undertaken by local governments in cities and towns. However, most people in these countries still live in rural areas. Small and/or rural jurisdictions make up the majority of governmental units in the countries surveyed.

There is increasing disparity between urban growth centers and agriculturally-based rural areas. Agriculture in many rural areas cannot play the role of growth engine. Due to the different local capacity of rural areas and the economic and demographic trends that continue to negatively affect rural communities, it is assumed that rural areas will fall further behind urban areas in terms of capacity to undertake local economic development initiatives. Lack of professional staff members, especially proposal writers, inadequate administrative capacity, and lack of experience in negotiating and management tend to disadvantage rural local governments. Moreover, traditionally low-wages, as well as emigration of youth and the highly educated, are demographic trends in rural areas.

As economic development activities expand at the local level, it could be assumed that small and rural communities will have to compete against other rural and urban regions in offering incentives to new and expanding businesses. Rural economies are generally small and undiversified. The loss of an industry can devastate a rural economy, while the opening of a single factory can nearly eliminate local unemployment (Deewes 2003). Many initiatives have small and medium-sized enterprise development on their list of objectives, but activities more often than not fail to give rise to broad growth of the rural economy.

Infrastructure investments in the form of roads, sewage, and water facilities, telecommunications and industrial parks lower production costs and have the potential to stimulate rural investment. However, there is little experience with strategies that would revitalize rural communities.

Local development policy is decentralized and is implemented by a local authority and organizations with the support of supranational organizations such as the European Union and the regional and central administration.

There are opportunities for municipalities to collaborate with one another to support local economies such as by supporting infrastructural improvements. Sub-regional cooperation efforts can increase the power of local governments in negotiating with firms, while interacting with the national government can provide economies of scale for training programs and other demand-side activities.

Sub-regional cooperation is becoming significant in local activities and several solutions in organizing cooperation have been created, by which municipalities try to compile their resources and coordinate their activities.

The increasing sub-regional cooperation between municipalities on a voluntary basis is a fairly significant trend. The reason for it is the small size of municipalities and the formal introduction of sub-regions. With the European Union, accession of local government has gained more importance in regional policy.

## 2.8 Bids for European Union Support

Local government involvement in local economic development is largely a consequence of the different internal policies of local authorities and leads to a quite different path of transformation, restructuring, and development. Many times it is built upon the experience with restructuring in Western Europe and the USA. Several common local government approaches to local economic support described in country reports are based on experiences in developed countries. However, the financial resources and economic circumstances enjoyed by Western European and North American local governments has made duplication of these models in Central and Eastern Europe almost impossible.

A range of economic development initiatives has been set up often with the support of donor organizations. International organization and bilateral donor assistance has often served as a catalyst for generating local economic development practices. Support to municipalities through economic and regional development projects funded by foreign donors has increased awareness of the positive impact of managing economic development amongst local government representatives. Another influence has been the possibility for local governments to manage their own property as well as public money from the European Union. The European Union included the concept of local development through structural funds and some community initiatives. The PHARE program's strategy opened the way for pre-accession policy initiatives similar to the structural funds operating in member states. Cross-national convergence can be seen in the institutional structures for the implementation of local economic development activities.

Of particular interest to local authorities is the influence they can hope to exercise over decision-making processes for the European Union pre-accession and structural funds. Local governments have become increasingly adept at identifying sources of European funding. The competition for those funds force local governments to place

projects in a strategic context and the strategy must be shown to be both reasonable and widely accepted. In any case, they usually need central government support to access such funds. Moreover, proposed projects should demonstrate a high level of matching funds from local sources—a large component of which is expected to come from state, region, or local governments. This consideration is based on the European Union principle of co-financing whereby no EU scheme is 100-percent funded without local co-participation.

It is undeniable that the wider national and international context significantly influences economic development initiatives in surveyed countries. European Union regulations and standards have provided the policy framework for the local economic development activities in all pre-accession countries.

## 2.9 Openness and Efficiency

There is no doubt that the scope for bringing about economic development through local policy is limited by forces operating in the national and international economies over which local government has little or no control. However, there is a general agreement that local governments have incentives to pursue economic development policies favorable to business interests. Politics at all levels involves the interplay and clash of various interests through organized groups and institutions. There is evidence of controversies over particular economic development policies. A question related to the controversy is the openness and transparency of the process and the extent of citizen participation. The process of decision-making is usually not particularly open and participatory, even if public money is used to subsidize companies or private firms. Granting tax concessions, loans, loan guarantees, etc., to local firms must be done on a consistent and open way.

The benefits of many LED activities (such as tax incentives and subsidies) are uncertain. There is a possibility that many local authorities' grants or provisioning of sites and premises subsidize firms that are not in need or which replace firms serving the same demand without subsidies. Firms end up with more benefit than necessary to relocate or to survive.

Local authorities often act without adequate analysis. This is mainly due to the political desire to be "doing something." Although quality statistics are a core component of local economic development strategies, statistical information on individual local economies has not been consistently collected and classified in many cases.

Local policies are rarely evaluated. Evaluation has been mainly confined to local economic development agencies that must justify the use of European Union or other foreign assistance funds. Similarly, the scattered research on economic development activities in Central and Eastern European countries provides little evidence of the outcome and impact of the initiatives described.

Local governments lack sufficient incentives to support evaluation. State funding should support evaluation of local economic development programs and support dissemination of the results of such evaluations, so that different programs can be compared. One step could be to interview the clients of economic development activities as occurred in Bulgaria.

### 3. CONCLUSION

The processes of globalization and devolution of competencies to local government have strengthened the position of local administrations. Local economic development policies in Central and Eastern European countries are both a reaction to economic transformation and response to the decentralization process, providing more discretion and options in addressing local problems. However, local economies are decisively influenced by national and supra-national policies and there is no illusion that economic development can arise only from local actions.

Local economic development has evolved into its present form over the last decade. Local government policies range from ambitious programs entailing a commitment to reducing unemployment to greater involvement of local businesses in formulating local policy. There are no strict models from which uniform approaches have emerged because the economic performance of localities is linked to national economic performance, and we cannot ignore the economic and socio-political differences between surveyed countries and municipalities at the national level. Discrepancies between countries arise partly due to their varying level of decentralization and also due to the varying amount of responsibilities devolved to local government. Certain local economic development instruments have become fashionable and more widely used, but the approaches and practices in countries surveyed are divergent. However, local economic development is an emerging field and local government has taken up the challenge in all countries.

Local government involvement in economic growth has been further debated. The issue of debate is not whether local government should be involved in economic development but what the appropriate role of government might be in promoting growth and the development of local economies. Many economic policy instruments which are not explicitly reserved for national government (e.g., exchange rate, job subsidies to employers) are available to local authorities although sometimes with major constraints. The rationale that supports local economic development policies is the capacity of localities to promote the development process: local issues such as the financial or administrative capacity of local government can be improved in order that they take part in the economic development process.

The economic development strategies emphasized by local government depend on the environment of their communities. A number of strategies have been adopted, but in general strategies followed by Central and Eastern European municipalities and regions try to improve their local economies by upgrading local resources through investment in infrastructure, training and upgrading human resources, and enhancing the entrepreneurial climate.

To implement development strategies effectively, municipalities large and small need to understand that local government, nongovernmental institutions, and the private sector are essential partners in the economic development process. There is also a need to assure an efficient and ethical public management system in developing and implementing sound development policies and programs, as well as the need to overcome unethical and inefficient bureaucratic problems.

Previously, local governments in Central and Eastern Europe were not proactive with respect to economic change. The need for early and lasting economic restructuring has been great in the most effected local economies; therefore, many local governments tried to develop tailored solutions addressing their circumstances. These efforts are limited by the lack of professionalism and access to funding. Local governments can act to the extent that its power and resources permit. Anyway, local economic development policies emerged to embrace a much greater perspective on local and informal mechanisms and on stimulating private investment and entrepreneurship. The potential is evident. There are almost unlimited needs and a range of possible responses. There are choices to be made about policies and about the scale of activities.

Local economic development policies have changed. These initiatives are now aimed at overcoming imbalances and promoting development using mostly local potential. Local governments need to take responsibility for the design and control of local economic policy and substitute an entrepreneurial culture for a traditional subsidy culture. When this is accompanied by measures that reduce bureaucracy and raise the level of managerial culture, the local policies adopted to promote economic development could be more effective and efficient in achieving their goals.

Having reviewed recent policy developments, this book identifies the great potential for local governments to tackle local economic problems. Local policies put into place respond to emerging challenges. In this chapter we have considered some of the main policies and strategies included in local government approaches to economic development. There is limited recent research on the strategies that local government in Central and Eastern Europe are employing in relation to local economic development. We do not claim that this study fill the gap. We do hope, however, that it makes a contribution to this end.

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# Local Government and Public Service Reform Initiative

Local Government and Public Service Reform Initiative (LGI), as one of the programs of the Open Society Institute (OSI), is an international development and grant-giving organization dedicated to the support of good governance in the countries of Central and Eastern Europe (CEE) and Newly Independent States (NIS). LGI seeks to fulfill its mission through the initiation of research and support of development and operational activities in the fields of decentralization, public policy formation and the reform of public administration.

With projects running in countries covering the region between the Czech Republic and Mongolia, LGI seeks to achieve its objectives through

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- Support and dissemination of in-depth comparative and regionally applicable policy studies tackling local government issues;
- Support of country specific projects and delivery of technical assistance to the implementation agencies;
- Assistance to Soros foundations with the development of local government, public administration and/or public policy programs in their countries of the region;
- Publishing of books and studies dealing with the issues of decentralization, public administration, good governance, public policy, and lessons learnt from the process of transition in these areas;
- Development of curricula and organization of training programs dealing with specific local government issues;
- Support of policy centers and think-tanks in the region.

Apart from its own projects, LGI works closely with a number of other international organizations (Council of Europe, Department for International Development, USAID, UNDP, and World Bank) and co-funds larger regional initiatives aimed at the support of reforms on the subnational level. The Local Government Information Network (LOGIN) and Fiscal Decentralization Initiatives (FDI) are two main examples of this cooperation.

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